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# A new Governance Architecture for European Financial Markets? Towards a European Supervision of CCPs

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**A new Governance Architecture for European Financial Markets?  
Towards a European Supervision of CCPs\***

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*Does the new European outlook on financial markets, as voiced by the EU Commission since the beginning of the Capital Market Unions imply a movement of the EU towards an alignment of market integration and direct supervision of common rules? This paper sets out to answer this question for the case of common supervision for Central Counterparties (CCPs) in the European Union. Those entities gained crucial importance post-crisis due to new regulation which requires the mandatory clearing of standardized derivative contracts, transforming clearing houses into central nodes for cross-border financial transactions. While the EU-wide regulatory framework EMIR, enacted in 2012, stipulates common regulatory requirements, the framework still relies on home-country supervision of those rules, arguably leading to regulatory as well as supervisory arbitrage. Therefore, the regulatory reform to stabilize the OTC derivatives market replicated at its center a governance flaw, which had been identified as one of the major causes for the gravity of the financial crisis in the EU: the coupling of intense competition based on private risk management systems with a national supervision of European rules. This paper traces the history of this problem awareness and inquires which factors account for the fact that only in 2017 serious negotiations at the EU level ensued that envisioned a common supervision of CCPs to fix the flawed system of governance. Analyzing this shift in the European governance architecture, we argue that Brexit has opened a window of opportunity for a centralization of supervision for CCPs. Brexit aligns the urgency of the problem with material interests of crucial political stakeholder, in particular of Germany and France, providing the possibility for a grand European bargain.*

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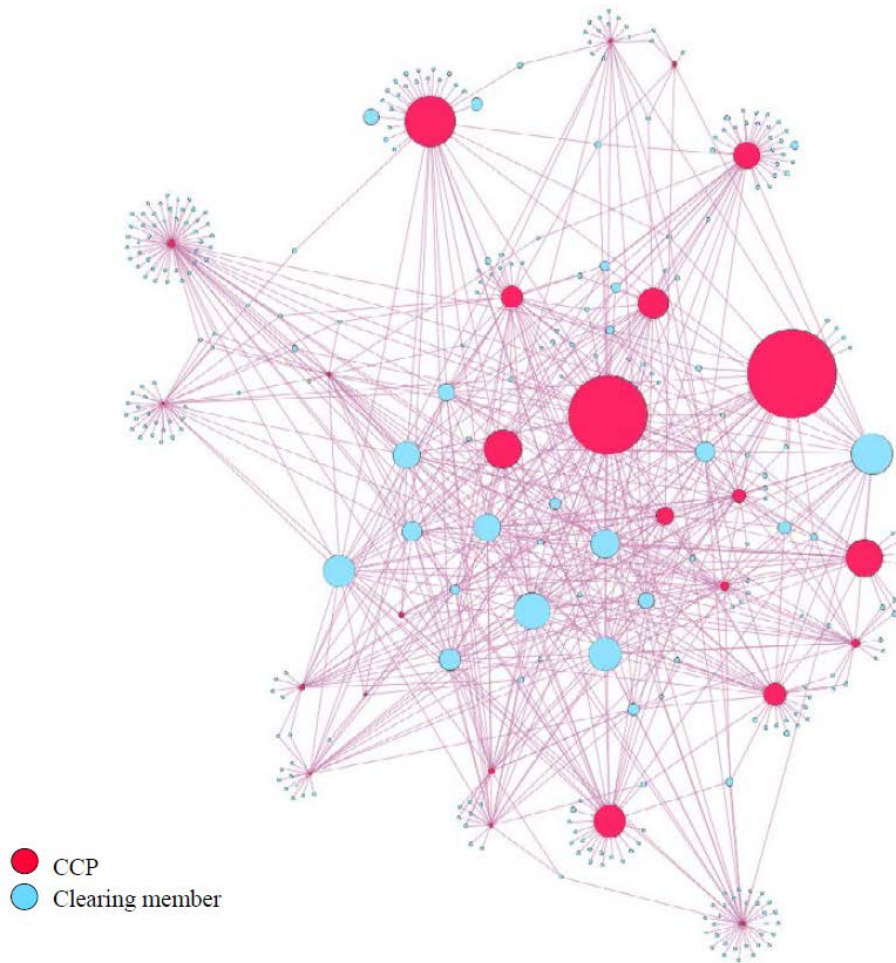
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## I. Introduction

In 2017, the chair of ESMA Steven Maijoor, stated that “in the context of the CMU, it is clear to me that successful EU financial markets need to go hand in hand with strengthened EU supervision” (Maijoor 2017, p. 2), signaling the attempt for a paradigm shift in the EU’s post-crisis approach to financial markets. Little noticed by those criticizing the Capital Markets Union (CMU) for repeating the EU’s pre-crisis drive towards further financial market integration without a common European supervision, this new approach not only strives to establish common European rules but also a centralized European supervision of these rules. This new perception of financial markets draws upon the insight that a successful integration of cross-border business requires a common European supervision to avoid regulatory and supervisory arbitrage, as the financial crisis has shown. These new dynamics are particularly evident for the supervision of Central Counterparties (CCPs), which became an issue of intense political struggles in the aftermath of UK’s decision to leave the EU. A CCP is a financial risk management institution that pools, nets and diversifies counterparty risk by setting itself between the buyer and the seller, guaranteeing the termination of a market transaction. In this way, CCPs shall contribute to the stability of the financial system as they lower the interconnectedness of clearing members (mostly banks) and limit contagion default risks among them (Cont and Kokholm 2012).

As CCPs proved to be resilient during the financial crisis, the G20 leaders agreed that clearing of all standardized derivative contracts should be mandatory. In the aftermath of the crisis, CCPs have become a crucial cornerstone of the financial architecture. However, this process also led to a market concentration which has made CCPs themselves too-big-to-fail (e.g. Duffie 2017). Furthermore, every clearing transaction is collateralized by a respective risk-adjusted margining, while contributions of the clearing members to specific default funds represent a second line of defense, before the CCP itself suffers losses. The increasing competition among the remaining CCPs, mainly located in France, Germany and UK, raised concerns over regulatory arbitrage as the strong competition incentivizes the reduction of regulatory costs such as margins for their customers in order to attract further business. This tendency towards “predatory margining” exposes CCPs to be under-collateralized when their stabilizing effects are most needed – in times of financial stress – making particularly the banking sector prone to significant spillover effects if a large CCP would collapse. Due to their crucial role in the derivatives clearing of banks, CCPs became central nodes of the financial system, which, if one CCP fails, immediately affects all other financial institutions (see figure 1 below).

**Figure 1: A visualization of a CCP-clearing member network**



Source: FSB 2017b, p. 8

Hence, CCPs replaced the issue of interconnectivity among banks with a complex network of CCPs and related financial institutions (cf. FSB 2017b). This immediate transfer of risks to the banking system as a whole by a failing CCP is an issue we will return to later, as it has particular implications for the recovery and resolution regime of CCPs on the European level.

The current home-country supervision increases the threat of a supervisory race-to-the-bottom as it allows National Competent Authorities (NCAs) to interpret the implementation of common European rules in favor of their national CCPs, leading to regulatory or even supervisory arbitrage. While the European supervisory architecture for banks has been swiftly centralized after the financial crisis, the supervision of CCPs primarily remained with the member states – despite the fact the crisis starkly revealed the shortcomings and inherent risks of such a national-based approach (e.g. Véron 2013). As governance concerns indicate that fiscal and supervisory responsibilities have to be aligned to avoid moral hazard, this ongoing fragmentation is mainly caused by a missing common European resolution fund for CCPs which prevents the creation of a common European supervisor. Hence, even the most

recent proposal by the European Commission for a revision of the European Market Infrastructure Regulation (EMIR) still relies on supervision through NCAs while creating a new (artificial) regulatory body within ESMA which shall ensure a common implementation of the common rule book – an approach which is even strongly rejected by ESMA itself (Maijoor 2018).

However, the decision of the UK to leave the EU may create a window of opportunity for those political actors who already saw an urgent need for a common European supervision of common rules for CCPs for a rather long time (Friedrich and Thiemann 2017) due to issues of regulatory and supervisory arbitrage (cf. Giovannini Report 2003). UK's withdrawal from the EU enables an alignment of these governance preferences caused by concerns over supervisory arbitrage with material interests and location policies. After the crisis, CCPs have become central financial infrastructures that continental European financial centers such as Paris or Frankfurt seek to attract, the crucial high-volume euro clearing from the City of London, acting as a coalition magnet (Jabko 2006) for member states with actually diverging political goals. This is leading us to the question whether the momentum will stop with the cumbersome compromise on CCP supervision, forged in 2017 in the aftermath of the Brexit vote or whether we will see a centralization of supervision for all CCPs under the umbrella of ESMA in the future. We argue that European policy makers should use this specific constellation after Brexit to implement a common European fiscal backstop for CCPs to open the door for a common European supervision. As the largest remaining European CCPs after Brexit will be located in Germany and France, such an approach does not only contribute to the financial stability of the Eurozone but would be beneficial for those two member states as well.

In the following, we trace the post-crisis path towards the new perception that market integration requires common supervision of common rules by focusing on the emergence and further evolution of the EU's regulatory and supervisory architecture for CCPs since 1999. We will examine how material factors inhibited substantial changes as well as how these material and ideational impediments for a centralized supervision were removed over time, creating a unique window of opportunity for a sustainable integration of European financial markets.

The paper proceeds as follows: In the following sections we will discuss the emergence of the current supervisory architecture from 1999 to 2012 and briefly examine the shortcomings of the current EMIR framework. We will review the evolution of CCP supervision in Europe which has been crucially affected by the announcement of the CMU in 2014 as well as by the development of a European recovery and resolution framework for CCPs and in particular by UK's decision to leave the EU in 2016. Next, we will critically reflect on the major impediments which prevented a further centralization of supervision in Europe in the past and discuss why a common supervision is beneficial for the EU. This leads us in the conclusion to argue for a grand European bargain.

## **II. The Rising Concerns over decentralized Supervision – The Path towards a New Perception of Financial Markets**

In the year 1999, the Financial Services Action Plan was released by the European Commission, pursuing the goal to identify and to abolish barriers for free asset flows within the EU. For that purpose, the European Council appointed the Lamfalussy Group to develop recommendations for the future architecture of supervision in Europe which stressed in its report from 2001 the positive effects of competition among CCPs (Lamfalussy Group 2001, p. 9), while recommending a home-country supervision (ibid, p. 13). While the Lamfalussy Group sought to design an appropriate European regulatory and supervisory structure, the Giovannini Group was simultaneously put in charge to identify barriers which impede the further integration of European capital markets and to develop strategies how those obstacles can be removed. The Second Giovannini Report (2003) was much more nuanced on the effects of increasing competition among clearing houses in Europe and mentions that a market consolidation will not necessarily lower competition among the remaining CCPs (ibid, pp. 26-27). The report further stresses the threat of a regulatory race-to-the-bottom, in particular in the context of a national-based supervisory structure (ibid, p. 32). However, the following Markets in Financial Instruments Directive (MiFID) (see MiFID 2004) as well as the joint standards of the CESR and ECB on clearing in 2004 (see CESR/ECB 2004) cemented a national-based supervision, creating the pre-crisis regulatory set-up.

In the aftermath of the financial crisis, CCPs have been promoted by global as well as European bodies, as they proved to be a resilient part of the financial system during the turmoil. Thereby, CCPs have become a central cornerstone of the European financial architecture post-crisis. Since then, the strongly increased competition among CCPs may motivate a consolidation in the sector, but also raised concerns over regulatory arbitrage. While the fragmented European supervisory architecture has been identified as a crucial source of financial fragility, regulators until recently have largely neglected that the same negative effects of home-country supervision may also apply for CCPs. In the following we investigate when the idea that sustainable financial market integration requires common supervision of common rules emerged and which obstacles impeded its implementation.

## **III. The Road to EMIR**

In the aftermath of the financial crisis the European Commission appointed the de Larosieré Group in October 2008 to develop recommendations for a revision of the EU's regulatory framework, recommendations which subsequently have been released in 2009. The report widely criticized the fragmented pre-crisis supervisory structure for a lack of trust and coordination among supervisors (de Larosieré Group 2009, pp. 39, 73-77). Furthermore, the group stressed the persistence of diverging

supervisory practices “whether the reason is to protect a national champion, restrict competition, preserve a national practice viewed as a competitive supervisory or regulatory advantage or just sheer bureaucratic inertia” (ibid, p. 75). While the supervision of CCPs was in the center of regulatory debates at that time, there was not even a consensus among the members of the group that there should be one single supervisory authority for banks (phone interview with a former member of the de Larosieré Group, 12 March 2018). Hence, the de Larosieré report only recommended an improved coordination among existing regulatory institutions.

The European Commission largely followed the recommendations of this working group regarding the to be newly created European Supervisory Authorities (ESAs), which emerged from the prior committee structure, “opposed to solutions such as full centralisation of supervision at the EU level, on which there is no consensus” (EC 2009a, p. 12). Rather pragmatically, the European Commission was arguing that the ESAs should “build on the existing structure and, when necessary, allow it to evolve over time” (EC 2009a, p. 12). Here already, a missing European resolution fund for these supervised entities was an important reason for the missing centralization of supervision for activities such as CCPs (phone interview with a former member of the de Larosieré Group, 12 March 2018), as we will see below.

One month after the agreement of the G20 to make the clearing of all standardized OTC derivatives mandatory (G20 2009), the European Commission released a communication which proposes two possible options: a) ESMA may get direct supervisory power or b) a college of supervisors under the umbrella of ESMA which recognizes the potential fiscal liabilities of the member states (EC 2009b, p. 5). In September 2010, the European Commission released a further proposal on the regulation and supervision of CCPs in Europe in which it stresses that “national competent authorities should retain the responsibility for [...] supervising CCPs, as they remain best placed to examine how the CCPs operate on a daily basis” (EC 2010a, p. 9). In its impact assessment, the European Commission also discussed the implementation of a direct supervision of CCPs through ESMA, which “would immediately ensure a coherent application of rules” (EC 2010c, p. 76). However, the Commission also stresses that this solution has an important shortcoming. A single European supervisor “does not align fiscal and supervisory responsibility” (ibid) as there is no “EU-wide resolution fund (or burden sharing agreement) [and] the fiscal responsibility would be left with the Member States” (ibid).

Hence, as in many other instances (Moloney 2014), the Commission proposed a supervisory architecture which aligns supervisory responsibilities with fiscal liabilities, making national supervisors responsible for the direct supervision of CCPs while colleges of supervisors at the European level shall be involved in the authorization process of CCPs (EC 2010b: 75). In the subsequent consultations with EU institutions, the Council of the EU (Council 2011a, b), the ECB (2011) as well as the European

Parliament (EP 2011) broadly agreed with the proposed supervisory architecture. In July 2011, the final steps towards EMIR were undertaken by the European Parliament which concurred with the conclusion of the European Commission that fiscal and supervisory responsibilities shall be aligned (EP 2011, p. 10). In March 2012 passed the final legislation on the regulation of OTC derivatives the European Parliament (EP 2012) and in July 2012 EMIR was finally released. While EMIR provided the preliminary regulatory and supervisory framework of CCPs post-crisis, developments in the area of recovery and resolution of CCPs had just started. Their delayed clarification (occurring only in 2017) was undermining the possibility to remove the most important obstacle for a common European supervisor – the possibility for burden sharing among member states.

#### **IV. The Shortcomings of the current Supervisory Frame under EMIR**

Since 2012, EMIR is the centerpiece of CCP regulation in Europe to ensure the financial stability of clearing houses. This regulatory framework 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 the price fluctuation risk of the assets.
2. All clearing members have to contribute to certain default funds that 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”.

In particular, EMIR stipulated that the supervision of those rules resides with the NCAs (EMIR 2012, p. 8), such as national central banks or financial services authorities. At the same time, ESMA should control a consistent application of EMIR (ibid, p. 3). 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” (Interview with a European CCP Supervisor, 11 October 2016), but not an independent supervisory agency, raising issues of regulatory and supervisory arbitrage. Due to these significant shortcomings of EMIR, the need for strong common supervision was brought up again in the context of the project of CMU from 2014 onwards and the review of EMIR in 2015, but no consensus could be reached on how to resolve it.



## V. The Capital Markets Union: The Rhetoric of Market Integration and Supervisory Convergence (2014-2016)

Right from the beginning of the CMU as a project, it was clear that the envisioned further removal of barriers to cross-border financial transaction may also create new issues of financial stability (EC 2015). The Commission entertained a new discourse on markets, which besides integration put the integrity and financial stability of the single market center stage.<sup>1</sup> The awareness regarding the danger of regulatory and supervisory arbitrage, in particular with respect to cross-border activities, led the European Commission to focus on supervisory convergence (EC 2017a). Given this sensitivity, the CMU project contained a program to encourage further convergence of supervision in Europe.

Aware that the removal of barriers may also create new challenges for the financial stability, the CMU was combined with a proposal to further develop the supervisory powers and capabilities of the ESAs. 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" (EC 2014, p. 13). Taking up this momentum, ESMA itself warns that "differences in supervision, and regulatory competition, undermine the achievement of the objectives of investor protection and financial stability. To have a truly single EU financial market, supervisory convergence [...] is needed to ensure that the single rulebook also results in a truly single EU financial market" (Maijoor 2014, p. 7). Whereas in the short-term, the Commission argues for further supervisory convergence, they note that potential main areas for expansion in the medium term include a broader mandate for CCP supervision. The calls for such an empowerment of ESMA grew stronger as the project of CMU that proclaimed the need for further supervisory convergence gained pace and was further emboldened by a decision of the European Court of Justice (ECJ), which removed an important barrier to the delegation of supervisory powers to ESAs. In 2014, the ECJ was dealing with the decision of the EU to prohibit short-selling in the wake of the European debt crisis through an intervention of ESMA. While the UK argued that this action may exceed the competences of ESMA, the court dismissed the case (ECJ 2014, p. 1). The court explicitly states that EU bodies, such as ESMA, can adopt further measures to facilitate the establishment of internal markets. In this way, the court overruled the Meroni doctrine from 1958 which defines fiscal liabilities as a legal red line of the delegation of supervisory powers. In this way, the court eliminated

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<sup>1</sup> Arguably, this aspect of CMU gained in strength with the replacement of Commissioner Jonathan Hill by Commissioner Valdis Dombrovskis 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" (EC 2014, p. 13).

legal uncertainties regarding a further extension of a supervisory power of ESMA, in particular with respect to direct supervision (Moloney 2015, pp. 532, 547-552).<sup>2</sup>

The movement towards centralized supervision gained further momentum with the longer term vision embraced in the Five Presidents' Report, which states that the CMU should not only improve cross-border capital flows within the EU but also "lead ultimately to a single European capital markets Supervisor" (Five Presidents Report 2015, p 12) with ESMA as the institutional tool to reach this supervisory convergence (EP 2015b, p. 8). Concretely, the European Commission proposed a strategy for further supervisory convergence (EC 2015a, p. 22), which finally led to the creation of a supervisory convergence standing committee at ESMA in 2015 (ESMA 2016a). In the meantime, ESMA has emphasized that "the systemic importance of CCPs is increasing while commercial incentives for CCPs to compete on the basis of risk remain" (ESMA 2016b, p. 9). However, this conclusion only led to attempts to improve the data quality regarding supervisory decisions (ibid.). In addition, ESMA stressed that "supervisory convergence does not mean that we will aim to converge to a one size fit all approach" (ESMA 2016b, p. 3) and that "[t]he overall goal is to strive for comparable regulatory outcomes" (ibid), in particular with respect to third countries (ibid., see also ESMA 2015, p. 20).

Due to those significant shortcomings of EMIR, the need for strong common supervision has been brought up again in the context of the CMU from 2014 onwards and the review of EMIR in 2015. So far no consensus has been 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 and Central Securities Depositories (CSDs) to a European level" (BoE 2015). They argued that the supervisory infrastructure should remain national with the colleges installed at the ESAs as the main agents to achieve convergence. In contrast, in the "Peer-Review" from 2016, ESMA identified diverging supervisory approaches across the EU regarding margin and collateral requirements as a pressing problem which has to be addressed (ESMA 2016c, pp. 41-42.). However, back in 2016, this conclusion only led to attempts to improve the data quality regarding supervisory decisions (ibid).

In summary, the pre-Brexit years are characterized by the formulation of a new long-term vision on market integration in Europe by the European Commission, emphasizing the need for one European supervisor (Five Presidents Report 2015). This shared new long-term vision on markets moves

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<sup>2</sup> A second court decision from 2015 was dealing with the revision of the ECB policy framework from 2011, in which the ECB had sought for powers to force CCPs to move from a non-euro EU country into the Eurozone. In its verdict, the court clearly states that the ECB does not have the competences to force clearing services to be located within the Eurozone and to have implicit regulatory power over clearing services (ECJ 2015). While a defeat in the short term, this decision would enable the ECB to define strategies to gain regulatory and supervisory powers over CCPs in the near future.

significantly away from the idea of regulatory competition linked to the UK pre-crisis (Financial Times 2016, Quaglia 2013) and towards sustainable markets with integrity. It is followed up by different CMU initiatives on supervisory convergence, taken up by ESMA. Nevertheless, the problem of *fiscal liabilities residing at the national level and supervision at the European level* persisted, plus the opposition by the UK to any transfer of supervisory powers. Despite these continued obstacles, in this period we can observe the build-up of a plausible case for a more active role of ECB and ESMA due to the establishment of ESMA as an entity with capabilities and due to the relativization of the limits on delegation of supervisory powers originally introduced by the Meroni case, which prior to 2014 had been seen as a major obstacle to ESAs direct engagement in supervision.

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 becomes crucial as both regulations are linked to the idea of a common European supervision in the context of the CMU. The forces opposing it, being the UK and the fiscal liability framework, would experience important setbacks with Brexit, which may open up a venue for changes in the governance architecture.

## **VI. The Erosion of the Counterargument of Moral Hazard through the Development of a European Recovery and Resolution Framework**

While the track record of failing banks is long and the experience of regulators dealing with bank failure is consequently large, public regimes for CCP recovery and resolution had to be made up from scratch. In October 2010, the European Commission released a communication which puts the development of a European recovery and resolution framework on the agenda of the EU – also for CCPs (EC 2010c, p. 3). The Commission sought to align the European recovery and resolution framework with the international work stream on recovery and resolution to ensure a global level playing field. However, such an alignment of actions also goes hand in hand with additional delays, arising in the drafting of a regulation. On the global level, the work on a recovery and resolution framework started with the FSB’s Key Attributes in October 2011 (FSB 2011, p. 5, footnote 3) which defines core elements of a recovery and resolution regime. In a simultaneous work stream, CPSS-IOSCO released its Principles for Financial Market Infrastructures (PFMI) in April 2012 which identifies CCPs as a potential source of contagion risks (BIS/IOSCO 2012, p. 5). It took nearly two years until CPSS-IOSCO published further guidance on a recovery framework and for the FSB to develop elements for a sound resolution regime, finalized in July 2017 (FSB 2017a).

In October 2012, the European Commission issued a consultative report on a European recovery and resolution regime, proposing several ways towards a European recovery and resolution framework

and requesting input on this. In this consultation, national treasuries mainly proposed national resolution regimes, a position shared with the European Parliament. Only the ECB recommended a central European resolution authority (ECB 2012, pp. 3-4). The lengthy process towards a recovery and resolution framework at the international level delayed a European agreement and four years after the first consultation, the European Commission published a recovery and resolution framework in November 2016. When the Brexit vote occurred in June 2016, the following consultations on the European recovery and resolution framework were already strongly shaped by issues of third-country regulation and the establishment of a level playing field. We argue that this creates a window of opportunity to eliminate the major obstacle of a common supervision for CCPs through the creation of a European resolution fund, following up on the suggestion of the rapporteur of the European Parliament who stated in January 2018 that “[i]n view of the systemic cross-border nature of large CCPs, future work on EMIR should aim to create a single supervisory, and resolution architecture as well as a single resolution fund for CCPs” (Weizsäcker 2018).

## **VII. Brexit and the current window of opportunity for Common European Supervision of European rules**

Besides the debates over a European recovery and resolution framework, the decision of the UK to leave the European Union also strongly affected the revision of EMIR as responses by crucial stakeholders to the initial EMIR proposal of the European Commission pointed to the need for a reaction. In particular, the French regulator AMF proposed an empowerment of ESMA regarding third countries (such as the UK in the future) to deal with the threat of a regulatory race-to-the-bottom (AMF 2017). The Commission seemed to take these concerns into account. It issued in May 2017 a communication for the upcoming legislative proposal, in which it proposes 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” (EC 2017a, p. 3). In its impact assessment for the revision of the EMIR supervisory framework in June 2017, the Commission discussed two possible ways forward.

The first option suggests the creation of a single European supervisory authority which can be either ESMA, the ECB or a newly created body. The Commission stated that this solution would ensure a coherent application of the common rule book. However, the creation of a single supervisor would also lead to significant shortcomings: a) misalignment of supervisory and fiscal liabilities and b) inadequate reflection of NCA’s and national central bank’s monetary policy mandates (EC 2017b, p. 59). While the latter cause might be solved by an adequate involvement of NCAs and central banks

within the organizational structure of ESMA, the unsolved question of fiscal burden sharing impeded the creation of a common European supervisor.

To take these obstacles into account, the Commission proposed that national supervisors would 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 will 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 will 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 (EC 2017b, pp. 58-59).

However, the establishment of an independent supervisory body within a supervisor would likely create additional confusions or even turf wars. Even the chair of ESMA does not embrace such a dual approach (Maijoor 2018, p. 8). Despite the fact that the recently passed amendments to this proposal by the European Parliament (EP 2018a, Financial Times 2018) improved and simplified this new supervisory mechanism within ESMA the establishment of a real single European supervisor is still not achieved. The Commission 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” (EC 2017b, p. 58, italics in the original). However, this only holds for CCPs *outside* the EU. While ESMA will be entrusted with far reaching supervisory competences regarding third-country CCPs, the supervision of CCPs *within* the EU would still follow the home-country principle to a substantial degree. Although the passed version of EMIR 2.2 is a significant improvement over the current supervisory architecture and is “going to be brutal” (K. Swinburne, member of the European Parliament from UK, in Financial Times 2018) for non-EU CCPs, even a simplified governance mechanism under the umbrella of ESMA would not fully address issues of regulatory arbitrage among CCPs.

These only limited changes for CCPs within the EU 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 and gained a track record of capabilities for supervision and expertise (Spendzharova 2017). Furthermore, the decision of the ECJ in 2014 to decide the legality of the short-selling ban in Europe has weakened the Meroni doctrine in Europe, facilitating the transfer of supervisory powers to ESMA (Goldmann 2017). 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 (EC 2017c, p. 19).

Furthermore, in the public consultation in summer of 2017, a majority of stakeholders agreed with the need for common supervision (EC 2017b, p. 117). 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 (cf. Maijor 2018).

Overall in the period after UK's decision to leave the EU, we observe an amplification of concerns on the continent regarding the dangers of CCPs located outside of the EU. Fears of regulatory and supervisory arbitrage with respect to national supervision of CCPs abound, in particular when they are located in third countries. The empowerment of ESMA with respect to third countries is an expression of the agentic capacity of the idea of supervisory arbitrage to act as a coalition magnet, bringing together Germany, France (finance ministries and regulatory authorities), ESMA, ECB and European Commission.

### **VIII. The Grand EU Bargain**

With Brexit, a crucial stakeholder that has blocked European supervision in the regulatory negotiations over CCPs in the past will leave the EU, with Germany and France remaining as the only two countries with major CCPs. Emphasizing subsidiarity, these actors are in principle open to a new constellation as the recovery and resolution framework for CCPs may mitigate their concern over fiscal liabilities. If Germany as well as France would push for a common supervision, one might see a further substantial increase in ESMA's direct supervisory powers over European CCPs.

Despite the fact that the business model of clearing houses and banks is completely different, both sectors are reciprocally linked to each other as struggling CCPs may create strong spill-over effects to the banking sector (and the other way around). Furthermore, if a European CCP fails, banks as primary members of a CCP are first liable before any bailout by tax payers takes place, spreading the initial losses in particular across the European banking sector. As such an event might only occur in case of a financial turmoil, the bankruptcy of a large CCP would strongly amplify an existing crisis, making a bailout of European banks much more likely. From a European perspective, it is hence hard to understand why a common European supervision as well as common fiscal backstop for banks exists while the supervisory architecture for CCPs remains fragmented. As every member state also has a national banking sector, it should be a common interest of the EU to prevent a regulatory race-to-the-bottom of CCPs. Besides this, even the two main locations of CCPs in continental Europe – France and Germany – would substantially benefit from a centralization of supervision, combined with a European fiscal backstop.<sup>3</sup>

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<sup>3</sup> Arguably, the instalment of a European resolution fund would reduce the tension between the European and the national level which resides in national resolution regimes. National regimes either risk to increase the overall

These reforms would also help to overcome a potential misalignment of the levels of supervision and fiscal liabilities, which might be an unintended outcome of the Bank Recovery and Resolution Directive (BRRD). While the supervision of CCPs is currently performed on a national level, liabilities might be shared already on the EU level, since the two largest CCPs in Europe – Eurex Clearing AG and LCH Clearnet SA – are also credit institutions within the meaning of the Capital Requirements Regulation (CRR) and thus fall in the scope of the BRRD (Banque de France, 2017, p. 2, EP 2017, p. 5). This allows a European burden-sharing of remaining losses through a potential bail-in of these institutions and, depending on specific circumstances, a potential access to the resolution funds for banks. Such an indirect European backstop violates the principle of placing supervisory activities and fiscal liabilities at the same level. In addition to this misalignment of incentives, the current BRRD set-up provides the resolution authorities with tools which are not necessarily suitable for the resolution of CCPs (EP 2017, p. 5).

A European CCP resolution fund could ameliorate the situation on both counts, facilitating the instalment of appropriate resolution tools and appropriate European supervision (Weizsaecker 2018). On the one hand, the use of more appropriate tools for the resolution of CCPs would reduce the overall costs to European tax payers. On the other hand, it would permit the establishment of a common European supervision of CCPs, aligning fiscal responsibilities and supervision at the appropriate level. In contrast, installing national resolution funds would risk re-instating a conflict of interest between the national and the European level, both in terms of supervision and in terms of resolution, which risks to either substantially increase the total costs of resolution of CCPs or to place them entirely on the national level. In sum, the establishment of a common supervision as well as a common European resolution fund would increase the resilience of the European financial system as a whole, while it would even ameliorate the status quo for Germany and France as the major European stakeholders.

## **IX. Conclusion and Policy Implications**

In this paper, we propose to use the Brexit as a window of opportunity to align the further integration of European financial markets with a centralized supervision of common European rules for CCPs. Our analysis of the regulatory debates over the last 20 years has shown that the awareness for the problematic combination of cross-border business and a fragmented supervisory architecture

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resolution costs caused by the failure of a CCP at the European level, due to the negative spill-over effects on other European banking systems that are not considered by national resolution authorities, or to increase the costs to the major stakeholders (Germany and France), in case their national authorities do take these spill-over effects into account. The latter is likely to happen since due to the interconnectedness of European banking systems, these spill-over effects in turn might threaten domestic banking systems. National resolution regimes would thereby bear the true European resolution costs on their own. Both solutions are suboptimal, either for the European or the national level.

significantly increased over time, leading to a new perception of financial cross-border business and financial markets in general. Although a common supervision is already reality for European banks, ideational factors and in particular material factors impede the creation of a single European supervisor for clearing houses up to date.

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” (EC 2017b, p. 59) and “substantially simplify the supervisory framework in comparison to the current supervisory arrangements” (ibid) 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?<sup>4</sup> 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.<sup>5</sup> 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 of a failing CCP, while the safety net of CCPs automatically implies burden-sharing of member banks beyond national borders (Maijoor 2018).

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 on 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.

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<sup>4</sup> 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.

<sup>5</sup> In a similar fashion stated by S. Maijoor at the panel discussion at the ILF Conference, Frankfurt at 24 April 2018.



The current industry infrastructure could help bring 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 AG). 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. Besides those benefits at the European level, a centralized supervision and a common fiscal backstop would also be in the interest of those member states with the largest CCPs in the Eurozone – Germany and France as locations. While the risk of a regulatory race-to-the-bottom within the EU would be prevented, both countries would benefit from a European guarantee for their national CCPs.

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 rules *and* common supervision. While the delegation of supervisory power over CCPs from national authorities to the European level is of course also onerous and problematic, we argue that these issues are only minor shortcomings and outweighed by the positive consequences. This white paper thus encourages the decision takers in the EU to be coherent and consequent in their decision making, transforming CMU rhetoric into policy action. It would imply a new relationship of the EU to single markets, moving from a damaging embrace of regulatory competition towards common rules and common supervision. Such a sign of policy learning would indeed be a striking, even if hard won achievement, born from the crisis and Brexit.

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