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BVI position on Euro clearing by systemically important third country CCPs

BVI[1] welcomes the proposal published by the EU Commission[2] to enhance the supervisory arrangements for EU and third-country CCPs in the interest of further market integration, financial stability and a level-playing field.

General remarks

German investment funds (UCITS/AIF) belong mainly to the clearing category (3) although a few funds are above the EUR 8 billion threshold calculated individually at fund level and are therefore classified within category (2). Some of our members use a UK CCP (e.g. LCH Ltd) for the clearing of euro-denominated derivatives (e.g. interest rate swaps). German fund management companies do not have direct access to a CCP. They use a clearing member (e.g. a bank or broker/dealer) to connect indirectly to a CCP. Most clearing members provide client clearing services to the end investors, thereby incentivizing them to use their preferred CCP. We have also observed market-led CCP solutions to facilitate direct access to clearing for end-clients.

We support the proposal to enhance the power of ESMA and the relevant national Central Banks (NCB) in the EU to supervise EU and third-country CCPs. We understand the necessity to differentiate between systemically important and non-systemically important CCPs.

We support the possibility to apply legal and supervisory arrangements allowing ESMA and the EU Commission to reject the recognition of a third-country CCP if such a clearing house is of such substantially systemic importance that compliance with the obligations laid down in Article 25 para 2 (b) does not sufficiently ensure financial stability in the EU. Such systemically important CCPs should apply for recognition within the EU in accordance with Article 14 EMIR.

To facilitate the management of systemic crisis situations, systemically-important CCPs for Euro denominated instruments should also be located close to the main decision making body for Euro issues, i.e. the ECB. Relocation of such CCPs should to the extent possible be effected without economic disadvantages to the users.

Main issues to be considered

Following the weaknesses of the derivative markets in terms of organization and lack of transparency exposed by the financial crises since 2008 the G20 mandated that all standardized OTC derivatives should be cleared through CCPs, thereby mitigating the counterparty risk present in the OTC derivative markets. CCPs have thus become effective vehicles for reducing systemic risk in the financial system. But CCPs have also grown in scale and scope to the extent that a disruption affecting a major CCP could have a significant impact on the clearing members and their clients (e.g. investment fund management companies). According to figures published by the ECB[3] UK CCPs clear approximately 90% of the euro-denominated interest rate swaps of euro area banks, and 40% of their euro-denominated credit default swaps.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 99 members manage assets of EUR 2.9 trillion in UCITS, AIFs and discretionary mandates. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the investments for 50 million private clients in over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.
[2] http://ec.europa.eu/finance/docs/law/170613-emir-proposal_en.pdf
[3] https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170620.en.html

BVI
Bundesverband Investment
und Asset Management e.V.

Contact
Phone +49 69 15 40 90 0
www.bvi.de

BVI Berlin
Unter den Linden 42
10117 Berlin

BVI Brussels
Rue du Trône 14–16
1000 Bruxelles

BVI Frankfurt
Bockenheimer Anlage 15
60322 Frankfurt am Main

Executive Board
Thomas Richter CEO
Rudolf Siebel MD

Equivalence-based recognition of third-country CCPs will not suffice
As a consequence of Brexit, the UK will become a third country in relation to the EU. However, the existing EU supervisory framework concerning the third-country CCPs under the EMIR regime was never developed to cope with systemically important non-EU CCPs active in Euro clearing.

The current supervisory EMIR-framework provides the EU authorities (e.g. ESMA, ECB and the national competent authorities (NCA)) and NCBs with limited tools for obtaining and accessing information in order to analyse and aggregate the CCP`s and their members counterparty`s risk exposures for euro-denominated clearing of derivatives. Under an equivalence regime, in the event of a financial crisis, the EU authorities would need to rely on information provided by the third country NCA and/or the NCB on the CCP and their members counterparty`s risk exposures.

Furthermore, in an event of a third-country CCP default, only its Central Bank can provide emergency liquidity assistance. The ECB and their members do not have legal powers to provide such liquidity facilities and would need to rely on the willingness of the national Central Banks of the third country to allocate such liquidity resources to the CCP.

Most importantly, EU regulators do not have direct supervisory powers with respect to third country systemically-important CCPs to take any action necessary in order to preserve the safety and financial stability of the Euro, the Eurozone and ultimately the EU.

In sum, we do not believe that a regulatory framework of third country CCP recognition based largely on equivalence recognition will be enough to provide sufficient protection in case of third-country SI-CCPs to ensure the stability of the Eurozone and EU financial system going forward.

Euro-clearing within the EU will be beneficial in the long-run
The clearing of euro-denominated derivatives within the EU will benefit further from the coherent underlying legal framework, especially the enforceability of EU (insolvency) laws under the scrutiny of the EU Court of Justice in the case of default by a systemically important CCP.

Also the clearing of euro-denominated derivatives may in the long-run have a positive netting effect on the initial margin and therefore reduced costs, for instance in the case of netting between euro-denominated exchange traded interest swaps and euro-denominated OTC interest rate derivatives within the same CCP compared to cross-currency netting efficiencies.

A co-location of systemically important CCP for euro-denominated instruments and the ECB is preferable as instances of default or severe systemic stress often occur after working hours or over weekends. Therefore a close proximity between the main Euro regulator, the ECB, and a CCP will facilitate the necessary ad-hoc contacts and meetings at all levels necessary for the resolution of potential or actual systemic stress situations.

Finally, one CCP for euro-denominated instruments is already present in Frankfurt, adding experience and an additional talent pool to the local financial centre. A location in or around the ECB location would not be a limiting factor to the business of other CCPs. The area can be accessed easily from anywhere within the EU. It provides a vast multilingual and experienced work pool and offers a broad range of educational, cultural and work opportunities for CCP personal and their families.