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EU and third-country CCPs: the risk of fragmentation?

The end of the Brexit transition period marks the start of a new regulatory paradigm between the European Union and United Kingdom especially with regard to UK central counterparties (CCPs).

In the EU, two important regulatory trends have emerged during the past few months.

First, the European Commission has reinforced the framework for managing CCPs' risks through the adoption of EMIR 2.2 but also with the recent adoption of the CCP Recovery and Resolution regulation (which includes a second tranche of skin in the game). In particular for third-country CCPs, EMIR 2.2 has allowed the enhancement of third-country CCPs supervision by ESMA through the revised recognition mechanism. EMIR 2.2 has also introduced a reinforcement of the application of EMIR key provisions for third-country tier 2 CCPs, considered as creating a systemic risk to the EU. However, with regard to euro-denominated OTC derivatives, EU authorities still consider Europe is too dependent to UK CCPs and does not benefit from sufficient supervisory powers.

Second, the European Commission has granted the UK a temporary equivalence decision for CCP clearing services in order to preserve financial stability, with the grace period running until the 30th of June 2022. In the meantime, the European Commission is encouraging EU-27 market participants to migrate their risk exposures from UK CCPs. Through a recent communication, the Commission reiterated the expectation that EU clearing members and market participants reduce excessive exposures to systemically important UK CCPs, in particular their euro-denominated OTC derivatives exposures.

There are clearly more questions than safe bets here and It is also important to understand the point of view of non-EU clearing members clearing euro transactions and the strategies they will follow. Could the European Commission take a strong stance and impose through regulation to non-EU clearers to clear euro-denominated instruments in the EU? If not, the risk could be to further fragment the derivatives markets and not control the potential risks or outcomes.

The end of the transition period has evidenced the necessity to adequately anticipate and coordinate the impacts on financial markets of structural regulatory changes. While the trading of shares has not undergone any major issues, due mostly to an effective anticipation by the industry, the trading of OTC derivatives – IRS and CDS - has suffered negative effects for both EU and UK financial markets. The lack of coordination in the application of the derivatives trading obligation (DTO) has generated a significant shift of the dealing volumes on US venues and penalized both EU and UK market volumes.

To avoid the risk of fragmentation, authorities should take into account political, risk and competition considerations. Maximising liquidity is key to CCP efficiency, providing clearing members with cross-margining benefits and clients with larger liquidity pools. A relocation policy of euro clearing that would only involve EU-based clearers and market players will damage those firms and would not meet the expected political goal of EU institutions. Indeed, to achieve this goal while maintaining CCP efficiency and financial stability, EU authorities will have to work closely with the industry to define the relevant measures to be implemented within a reasonable timeframe.