12th May 2015

EACH response – European Commission public consultation on 'Building a Capital Markets Union'

1. Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of CCPs in Europe since 1992. EACH currently has 20 members from 16 different European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

EACH welcomes the opportunity to respond to the European Commission green paper 'Building a Capital Markets Union'.

Below you will find the responses to the questions of the public consultation paper that we believe are relevant and have an impact on CCPs.

2. Response to specific questions

Improving market effectiveness – intermediaries, infrastructures and the broader legal framework

Q23: Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?

Yes: X

No:

Comments:

Introductory remark:

EACH supports the Capital Markets Union (CMU) as a project that will provide the opportunity to achieve several important goals that will make the EU more integrated, efficient and safer: ensuring global regulatory consistency, implementing a European insolvency regime, harmonising rules with regard to the Giovannini Barriers and simplifying the authorisation processes of new products.

Importance of derivatives markets

In addition to funding, companies require capital markets for hedging and minimising the risks that arise from price fluctuations. Therefore, the related derivatives markets are essential for the Capital Markets Union, as derivatives allocate various risks to where they can be managed most efficiently and thus provide benefits. Derivatives provide risk protection with a minimum upfront investment and capital consumption. They allow investors to trade on future price expectations thus improving the efficiency of price discovery. As a consequence, derivatives markets reduce uncertainty and costs in economic activity. Derivatives markets promote financial stability and facilitate risk management.

Global consistency

Any measures taken in the context of the capital markets union should be aimed to avoid the potential for regulatory arbitrage at global level.

Q24: In your view, are there areas where the single rulebook remains insufficiently developed?

Regulatory Reconciliation/Consistency check of regulatory initiatives

The Capital Markets Union should not be seen as "de-regulation", but rather re-regulation. Loose ends need to be reconciled with regard to finalisation, implementation and application of existing regulatory initiatives, making sure that these avoid any unintended consequences. Surplus and misdirected regulation raises costs for businesses, utilising valuable funds that could instead be turned towards innovation and growth creation. The overall aim should be to establish a more attractive environment for companies and investors.

In the last years the European Commission launched important regulatory initiatives (CRD IV/CRR, MiFID II/MiFIR, EMIR, CSDR, AIFMD, UCITS V etc.) that should be integrated under the umbrella of the Capital Markets Union. The Commission should avoid making significant further changes to market structure. The Capital Markets Union should reduce the regulatory burden to what is essential, build up an efficient supervisory structure and ensure a global level playing field. Existing regulatory initiatives should be aligned with and not contradict the goals of the Capital Markets Union project (e.g. T2S, FTT)

Given the global nature of capital markets, coordination of supervision both within and outside Europe is important in order to ensure a global level playing field and maintain European competitiveness. The overall aim should be to establish an attractive environment for companies and investors.

Harmonisation

Fostering the harmonisation of rules and standards is essential to eliminate costly barriers (especially the Giovannini barriers) and reduce complexity for investors and companies. Initiatives in this area, building on the Single Rule-book as a harmonised regulatory framework, should increase the attractiveness and returns on investment, thereby stimulating economic growth.

The Capital Markets Union is likely to be a good vehicle through which to dismantle some of the cross-border barriers preventing the development of integrated European markets. Significant fragmentation still exists in the public domain, e.g. in securities law, insolvency law, accounting standards for SMEs, and tax procedures (e.g. withholding tax procedures) and investment fund services.

Global consistency

Any measures taken in the context of the capital markets union should be aimed to avoid the potential for regulatory arbitrage at global level.

Q27: What measures could be taken to improve the cross-border flow of collateral? Should work be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border?

Measures to be taken to improve the cross-border flow of collateral

Following the recent financial crises, market participants faced a significant increase in the use of collateral to secure operations (e.g. operations with central banks, margin requirements, reverse repo transactions). It is therefore important for market participants in Europe to optimise the use of collateral and do so by **targeting one single pool of collateral** which allows real time substitution. Cross border solutions (e.g. Inter-operability between ICSDs and between domestic CSDs and ICSD) will allow banks to have one single pool of collateral.

The implementation of European legislation and other non-legislative initiatives aimed at harmonising settlement across the EU helps improve the cross-border flow of collateral. Examples are the **CSD Regulation and the T2S project**. Both will facilitate settlements across CSDs and ICSDs, fostering greater financial integration.

We support the development of tools which allow collateral optimisation, such as **triparty repo solutions**. Triparty repo transactions, for which post-trade processing (e.g. collateral selection, payment and settlement, custody and management during the life of the transaction) is outsourced by the parties to a third-party agent, have the advantage to allow for real time substitutions and optimisation regarding the type of collateral delivered.

Lastly, we support the **ECB decision in May 2014 to remove the repatriation requirement**, part of Correspondent Central Banking Model ("CCBM"). This decision made it easier for Eurosystem counterparties to use assets, held as collateral at their domestic CSD, for their Eurosystem credit operations. The removal of the repatriation requirement eliminated the need to move assets from the investor securities settlement system ("SSS") to the issuer SSS in CCBM operations. We would encourage all EU central banks to embrace this solution.

Improving the legal enforceability of collateral and close-out netting arrangements cross-border

Financial Collateral Legislation

We would support a **Financial Collateral Harmonising Regulation as a long term aim, with convergence of existing practice under the Financial Collateral Directive as a medium term aim**. The key issue is to ensure that collateral arrangements are easily enforceable whether they are on the basis of title transfer or a security interest (and irrespective of the jurisdiction where the collateral is held and the jurisdiction of the grantor). The Financial Collateral Directive is useful in that regard. In order to improve legal enforceability of collateral (which supports effective risk management and efficient markets), we would welcome (in the long term) a review of the Financial Collateral Directive to make sure it is still fit for purpose, particularly in relation to cross-border arrangements. An alternative would be the introduction of a European legal framework for the harmonisation of rules regarding the methods allowing for effective acquisition of securities and collateral interests therein and the regime regarding good faith acquisition, building on the Financial Collateral and Settlement Finality Directives. This could include looking at the different types of security interest which exist under the law of different jurisdictions and ensuring there is a harmonised position on how such security interests are taken. It could also encompass some of the ancillary arrangements which surround collateral arrangements.

For example, we understand that powers of attorney are automatically revoked on the insolvency of the grantor in some jurisdictions but not in others.

It has also been observed that even netting-friendly jurisdictions may have inconsistent laws regarding:

(i) the scope of eligible parties allowed to use close-out netting: for instance, insurance companies or special purpose vehicles used by banks in the context of securitisation might or might not be netting-eligible, depending on the jurisdiction;
(ii) the eligible types of contracts: jurisdictions differ, for instance, in their assessment of whether physically settled derivatives should be netting-eligible; and the extent to which close-out netting is compatible with the pari passu principle: for instance, the applicable regime regarding knowledge by the solvent party of the approaching insolvency of the counterparty differs across different jurisdictions.

Exemption of cleared derivatives from bail-in powers
In addition, it is worth noting that CCPs could be exposed to the risk that different resolution authorities take differing views as to whether cleared derivatives could be bailed in or not, which could then impact the enforceability of collateral and close-out netting arrangements by a CCP in a clearing member's default scenario. We believe that resolution authorities should take a consistent approach on this matter and exempt cleared derivatives from bail-in powers. Bailing-in liabilities owed to CCPs could present significant challenges to the proper operations of CCPs and undermine financial stability. As you will appreciate clearing of trades through CCPs helps to reduce systemic risk and risk contagion. This is largely as a result of the comprehensive risk management arrangements employed by CCPs. An important aspect of risk management is that in normal circumstances a CCP runs a 'matched book' (i.e. any loss-making positions to which the CCP is counterparty are always matched by profit-making positions). In the event of a default, CCPs have rigorous procedures for the closing-out of clearing members' positions to re-establish a matched book. These arrangements crystallise losses at the earliest possible stage and prevent contagion to other market participants. The inclusion of centrally cleared transactions in the bail-in provisions could potentially prevent CCPs exercising such powers. For example:

- A CCP may be unable to default a clearing member or liquidate a position with a clearing member simply because it is subject to bail-in provisions. This could place the CCP in a position where it holds an unmatched book (and without access to the clearing member's default resources to make good any shortfall), thereby increasing systemic risk.
- It could also impact the effectiveness of a CCP's default procedures (which are designed to recreate the matched-book in a default) if a CCP is required to deal with

a contract on its 'bail-in' terms and could therefore increase risk contagion to other market participants.

- Furthermore it may result in market uncertainty if it was not clear that all liabilities owed to a CCP, including net sums due, were excluded from the scope of the bail-in power.

Q29: What specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market?

It would be extremely useful for CCPs if European insolvency legislation (as it applies to defaulting Clearing Members) could be harmonised on the basis that a **CCP's rights in insolvency** are clearly protected. The cornerstone of this would be to ensure that all European insolvency regimes facilitate the exercise by a CCP of its obligations under EMIR. These include, but are not limited to, the rights of a CCP to close-out positions and apply collateral and to port positions and collateral using the powers set out in its default rules notwithstanding any prima facie infringement of insolvency laws giving effect to the pari passu principle.

Persistent legal issues relating to securities holding and transfers are strongly connected to domestic insolvency law and property law. Both are traditionally applied on a mandatory basis. Therefore, market participants are unable to simply choose one jurisdiction's law, as they might regulate their contractual relationships, and have the entire situation governed by it. Many investors are unaware of, and may sometimes be sceptical about the order of priority on insolvency in other member states. This may deter many of them from cross-border investment activity. Cross-jurisdictional legal certainty heavily depends on the compatibility of these mandatory domestic laws.

In the medium term, CMU can build on the two Giovannini reports by taking a functional approach to harmonisation, rather than addressing fundamental legal concepts. This would allow Member States to opt-in to changing technical arrangements without changing laws or taxation arrangements. We believe there is scope among the remaining "Giovannini Barriers" defined by the Legal Certainty Group to be addressed in this way (e.g. the methods for acquisition and disposal; the minimum content of the acquired position; effectiveness and reversal; the protection of the acquirer; priority issues; the integrity of the number of securities; instructions; and, the possibility of attachments.)

One way of dealing with these issues may be the **revise or expand the Settlement Finality Directive** and place a greater emphasis on ensuring **harmonised implementation across Europe**.

Q31: How can the EU best support the development by the market of new technologies and business models, to the benefit of integrated and efficient capital markets?

A more efficient process to approve new risk management products

EACH believes that the EU could best support the development by the market of new technologies and business models, to the benefit of integrated and efficient capital markets, if the current processes through which central counterparties (CCPs) launch innovative risk management products and improve their risk management models are rationalised.

CCPs are financial market infrastructures that reduce and manage the counterparty risks in financial markets by becoming the buyer to every seller and the seller to every buyer of an original trade. They perform this function through robust risk management tools, such as multilateral nettings, ex-ante collateralisation of market positions and a pre-agreed set of legal and operational rules in case of counterparty default.

During the recent financial crisis, CCPs demonstrated their ability to successfully manage a default and prevent contagion across market participants. As a result of the crisis, regulators around the word agreed to support clearing through CCPs as a way to improve risk management in the OTC derivatives market. In the European Union, this requirement was implemented through the European Market Infrastructure Regulation (EMIR).

EMIR sets minimum standards regarding the governance arrangements of the way European CCPs, conduct business (e.g. transparency), the capital they must hold and their risk management framework.

We believe that **the authorisation of new products and improvements to CCP risk management models should be streamlined in order to achieve a more efficient capital markets union in the EU**. CCPs currently face the following challenges when launching a new product or improving their risk management models:

- **Timing** – The timing to approve new products is excessively long. Based on the experience of EACH members, it can in some circumstances take a CCP close to or longer than one year to get a new product approved. **In order to address this concern, EACH proposes**:
    - The application of one clear and official procedure equally across all CCPs and all jurisdictions in the EU. The factors considered when determining any material changes (Article 49) to a CCPs current suite of products should be disclosed by regulators to CCPs. This will help the CCPs streamline their business strategy and can then attempt to prioritise their product launches/developments.
    - The assessments by the competent authorities should be targeted and specific to those elements of an additional service or activity which are <u>new</u> to that service or activity.
    - A more detailed description by the regulators of the data and documents to be provided in the application, to speed up the procedure.
- **Governance**
    - Repetition of assessment – The assessments currently performed by some regulators lead to the repetition of assessment which may not be directly related to the improvement proposed and which had already been approved by authorities during the original article 17 authorisation (e.g. during the authorisation of the CCP).
    - Overlapping verifications - EACH believes that the current process to approve new products or authorise an enhanced version of the CCPs' risk models can sometimes lead to a situation where the same verifications occur more than once. **In order to address this concern, EACH proposes**:

    - To clearly define the role of each regulator (national competent authorities, ESMA, etc.) in the procedure. In our opinion, the ESMA validation referred to under Article 49 should be a high-level check to confirm that the National Competent Authority has properly carried out its review and addressed all relevant issues with regard to the CCPs' models, which according to EMIR must also be validated by an independent party.
    - To enhance the transparency around the schedule of College meetings and increased its frequency (potentially once a month) with the publication of the dates (which may be cancelled) so as to ensure there is both transparency and protections to avoid bottlenecks.
- **Legal certainty** - EACH members believe that the current approval process provides too much room for interpretation. This is particularly the case with regard to the review of models, stress testing and back testing (Article 49), where the meaning of 'significant' and the validation timeline are open to interpretation by the competent authorities. If any change is defined as 'significant', the ability for the CCP to introduce new products would be slowed down, even if the changes are similar to already cleared products.
- **Equal treatment and competition among CCPs** - EACH members believe that the same process for the authorisation of new products and improvement of risk models should apply to all CCPs, rather than depending on the interpretation of national authorities. An unclear and lengthy approval process could particularly put the smallest CCPs at a disadvantage when trying to expand their activities.

EACH believes that addressing these concerns through a more efficient process to approve new products in EMIR will facilitate innovation in the EU and provide a more efficient and safer capital markets union. In order to fully benefit from this process, it will be crucial that this new efficient process is implemented as soon as possible, avoiding waiting until the expected EMIR review is completed, which may not happen for several years.