Benoît Cœuré: The international regulatory agenda on CCP links

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the European Systemic Risk Board (ESRB) workshop on CCP interoperability arrangements, Frankfurt am Main, 2 November 2015.

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Ladies and gentlemen,

I would like to thank the European Systemic Risk Board for inviting me to speak on such an important topic. Central counterparty (CCP) interoperability is a relatively new development in the European clearing landscape – the first interoperability arrangements between two European CCPs were only established in the early 2000s, covering transactions on government bonds and equities. Nonetheless, Europe has been at the forefront of the global debate on interoperability arrangements and is beginning to reap the benefits of the knowledge it has built up so far[1]. CCP interoperability has undoubtedly improved the efficiency of the EU post-trading infrastructure. However, it is also fair to say that industry participants and regulators are facing a number of ongoing questions regarding the full implications of CCP interoperability in terms of competition, financial innovation and systemic risk.

In this address, I will try to give an overview of the main benefits that CCP interoperability has brought to the EU financial system, and outline why in my view interoperability should be supported and enhanced. I will also discuss some of the challenges CCPs and authorities are currently facing in establishing and managing safe interoperability arrangements. Lastly, I will raise a number of questions, which I believe are important to the implementation of CCP interoperability going forward and which could warrant a place on the international regulatory agenda.

CCP interoperability has improved the efficiency of the EU post-trading landscape, and is one aspect of broader initiatives to reduce fragmentation in financial markets

First of all, I would like to say that it is rather topical to be discussing CCP interoperability, particularly as just a few weeks ago the Commission released its Action Plan on Building a Capital Markets Union. One of the priorities put forward by the Commission for this ambitious project is to step up efforts in removing barriers to the cross-border clearing and settlement of securities. CCP interoperability can play a key role in meeting this objective, as the Giovannini Group highlighted in 2001 already. In fact, it is thanks to the work of this group that some barriers were removed and links started being established.[2]

Indeed, supporting CCP interoperability seems particularly relevant in the context of the EU financial system, where securities and funds need to flow across borders, but where clearing and settlement infrastructures have traditionally been largely domestic in nature. On one hand, CCP interoperability allows financial entities to access centrally cleared markets across the EU and to transact with multiple counterparties without bearing the costs of joining multiple CCPs. Thus, it is possible for participants to expand the range of products they can trade while preserving the benefits of using a single clearing venue[3]. On the other hand, it

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1 See: European Securities and Markets Authority (2015), "Final Report : the Extension of the Scope of Interoperability Arrangements".

2 See: The Giovannini Group (2002), "Cross-Border Clearing and Settlement Arrangements in the European Union", Section 5 (Barrier 2), European Commission, Economic Papers, No. 163.

3 See: Garvin (2012), "Central Counterparty Interoperability", Reserve Bank of Australia Bulletin, June Quarter 2012.

can also provide market participants with a choice of multiple CCPs through which to clear products traded on the same venue. Interoperability can reduce demand for collateral assets to meet margin requirements, by allowing participants to concentrate all their clearing activity within a single CCP, and by increasing netting efficiency across CCPs[4]. However, we should also keep in mind that covering the exposures resulting from interoperability arrangements may create a need for extra collateral[5]. Overall, interoperability has the potential to help reduce the fragmentation in financial markets, spur competition and innovation, and decrease the cost of central clearing.

To sum up, there is a broad consensus among market participants that today's interoperability arrangements covering cash equities, fixed income products and certain exchange-traded derivatives have improved the liquidity of these markets. I think it is therefore safe to say that the implementation of CCP interoperability has benefited clearing members and their clients alike.

If they are prudently managed and supervised, interoperability arrangements can also be beneficial for the resilience and stability of the financial system. The fact that the same markets are cleared by several CCPs increases the likelihood that these markets can continue to be served in the event that one CCP suffers an operational or financial failure – although it should be pointed out that a CCP failure is an extremely unlikely scenario.

One issue to be further analysed is whether interoperability arrangements could facilitate the porting of open positions to an alternative CCP, thus preventing a total close-out of transactions and containing any potential knock-on effects to clearing members. Discussions regarding the global and EU framework for CCP resolution are still under way, and more work will need to be done to assess the extent to which interoperability can help during a resolution process; however, there are reasons to believe that it could indeed be an asset from the perspective of CCP substitutability[6]. Furthermore, greater netting efficiency – which is one of the effects of CCP interoperability – can lead to financial stability benefits such as lower expected counterparty exposures and lower collateral demand, when compared to a situation in which the clearing landscape would be fragmented[7].

While interoperability arrangements might give rise to contagion risks in the event one linked CCP were to default, the financial stability benefits resulting from increased netting efficiency are likely to outweigh the potential contagion costs – providing that interoperability arrangements are appropriately supervised – as the failure of a CCP is an extremely unlikely event[8]. In fact, the development of interoperability arrangements could provide a solution for reaping the benefits of reduced fragmentation in the CCP landscape, without incurring the monopoly costs linked to a single clearing provider.

As I mentioned earlier, CCP interoperability should be understood within the context of broader market-led efforts to improve market infrastructure integration. In the area of securities settlement, integration has increased substantially in the last 15 years as a result

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4 See: Committee on the Global Financial System (2011), "The macrofinancial implications of alternative configurations for access to central counterparties in OTC derivatives markets", CGFS Paper n° 46, November 2011.

5 See: Singh, M (2013), "Making the over-the-counter derivatives markets safe: a fresh look", Journal of Financial Market Infrastructures, 1(3), Spring 2013.

6 See: Coeuré, B (2015), "Ensuring an adequate loss-absorbing capacity of central counterparties", Special invited lecture at the Federal Reserve Bank of Chicago 2015 Symposium on Central Clearing, Chicago, 10 April 2015.

7 See: Duffie, D; Zhu, H (2011), "Does a central clearing counterparty reduce counterparty risk?", Review of Asset Pricing Studies, 1(1), July 2011.

8 See: Cox, N; Garvin, N; Kelly, G (2013), "Central counterparty links and clearing system exposures", Reserve Bank of Australia Research Discussion Paper, October 2013.

of the establishment of links between securities settlement systems. Furthermore, the launch of TARGET2-Securities earlier this year has given Europe a new single securities platform. It has helped optimise the use of liquidity and collateral, as well as pushing forward the harmonisation agenda in Europe. These initiatives have brought us closer to our ultimate goal of a fully integrated financial market and have laid down fundamental elements of market infrastructure integration. Going forward we should continue to build on collaboration between authorities and the industry with the aim of enhancing the integration of post-trading infrastructures, fostering innovation and efficiency, and ultimately benefiting end users and the real economy.

Nonetheless, we should bear in mind that achieving greater integration in the field of central clearing may create different challenges than in the case of settlement, namely with regard to risk management.

The regulatory framework established at EU and international level ensures that interoperability links are managed in a safe and prudent manner. However, CCPs face a number of challenges in applying these risk management standards

Building on the foundations established by the CPMI-IOSCO *Principles for Financial Market Infrastructures*, EMIR sets out strict binding rules for managing the potential risks stemming from interoperability arrangements.

These rules relate to the provision of margins between interoperating CCPs, the necessary harmonisation of CCP risk management frameworks and the use of inter-CCP resources in default situations. Crucially, the establishment of interoperability arrangements is subject to the approval of colleges that are set up under EMIR in order to supervise CCPs. Cooperative supervision arrangements are particularly necessary with regard to interoperability arrangements, which require a high level of scrutiny from a number of relevant authorities, including the supervisors of the two interoperating CCPs and the central banks of issue of the most relevant currencies cleared through the link.

Nonetheless, we should not underestimate the challenges CCPs face in establishing and managing safe interoperability arrangements. The task of harmonising risk models and ensuring that interoperating CCPs cannot contaminate each other in the event of a clearing member default is not straightforward. While CCP interoperability is and should remain a market-led process, the close involvement of all relevant authorities is vital in ensuring that CCPs have appropriately compared their risk management frameworks and taken the necessary steps to make these models compatible with each other. Authorities also have a key role in making sure interoperating CCPs have comprehensively assessed the risks they pose to each other. As an example, CCPs which enter into an interoperability arrangement must collect and exchange margins to cover their reciprocal exposures. Under EU rules, these resources are not part of the CCPs' regular default waterfalls, and are exclusively provided for the purpose of covering losses from one interoperating CCP going into default. In other words, they cannot be used to cover other types of losses, such as a participant default. Authorities must ensure that the resources contributed by one CCP are fully protected from potential defaults or stress events which could occur in the other CCP(s).

While I believe the current European regulatory framework achieves a high degree of protection, it could be further improved by reducing the scope for regulatory interpretation, and by making sure that the same outcomes are achieved by all regulators and supervisors when dealing with interoperability arrangements.

At present, the requirements related to CCP interoperability set out in EMIR Level 1 and in the dedicated ESMA guidance leave room for some degree of interpretation by competent authorities. More granular rules may need to be defined in EMIR so as to address some of these issues and provide greater clarity to supervisors and regulators. Authorities could work together to identify such potential issues, and discuss whether and how additional guidance should be incorporated into EMIR. Allow me to share two examples of areas where the need for more rules could be explored: first, the criteria and requirements for harmonising the risk models of interoperable CCPs; and second, the treatment of exposures resulting from interoperability within CCP stress testing frameworks. While a degree of clarification may be beneficial, we should also recognise that regulation probably cannot address all issues related to such a complex subject as CCP interoperability, and that competent authorities will need to continue playing a role in deciding how best to tackle certain issues not entirely dealt with under the legislation.

Looking ahead, I believe that market confidence in the safety of interoperability arrangements will be further strengthened with the entry into force of the CPMI-IOSCO *Public quantitative disclosure standards for central counterparties*.

Starting in January 2016, all CCPs with interoperability arrangements will be required to publish data on the volume of activity cleared through these links. They will also have to publish data on the financial resources provided and collected to cover exposures resulting from these links, and on the results of back-testing performed on the level of coverage of these resources. Transparency towards market participants is paramount, especially for a relatively new and complex practice such as interoperability. The plan to release this data across all jurisdictions is one of the major policy achievements reached at international level.

In sum, I am confident that the current EU regulatory framework and the rules established at international level ensure a high overall level of safety for CCP interoperability arrangements. However, looking ahead, several questions still remain open to discussion. As I have already mentioned, authorities and the industry need to work together to examine these issues and to continue to enhance the safe and efficient implementation of interoperability arrangements

An initial question to be examined is ***whether regulators should set any limits on the potential scope of interoperability***.

At the moment, EMIR only explicitly provides for interoperability arrangements relating to cash products and money market instruments; however, the Regulation does state that the scope of interoperability should be subject to future review. The existence of this review clause, as well as the forthcoming entry into force of the mandatory clearing obligation, make discussions concerning the scope of interoperability rather topical. Market participants and authorities will need to exercise caution in determining whether to extend the scope of interoperability further, for example to OTC derivatives links. ESMA has in fact recommended this extension for exchange traded derivatives, but not for OTC derivatives[9]. Potential credit exposures are greater for OTC derivatives, and the cost of assessing risk and making risk management models compatible are clearly higher. It should be noted that no OTC derivatives links have yet been established in the EU, nor does there appear to be any market demand for such links for the time being.

Regulators need in general to ensure they do not set any excessive barriers to innovation: the costs and risks of interoperability are unambiguously higher for OTC derivatives but the benefits are nonetheless there, including in terms of having more competition. If CCPs can deliver interoperability for OTC derivatives in future in a safe and efficient manner, then we should seek to ensure they are not prevented from doing so because of excessively restrictive regulations. Interoperability for OTC derivatives may also be important in view of the forthcoming entry into force of the clearing obligation: indeed, the establishment of interoperability arrangements might help ensure that these markets remain sufficiently liquid once they are subject to mandatory central clearing. However, it will still be a far greater challenge to implement interoperability for more complex products such as OTC derivatives than for the relatively standard products which are currently covered. Authorities will need to

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[9] See: ESMA (2015), “Final Report : the Extension of the Scope of Interoperability Arrangements”.

be fully aware of micro and macro-prudential risks when assessing such links, and the additional risk control measures will come at a cost for CCPs and their clients.

A second question which warrants attention is ***whether interoperability is likely to shake up, or even destabilise, the EU CCP landscape***.

Indeed, the EMIR requirements regarding interoperability, together with the MiFID/MiFIR requirements concerning trading-venue access to CCPs, could have certain implications for the future shape of FMIs in Europe. One of the issues that should be closely watched is how interoperability might contribute to increasing competition in the CCP landscape, and what effects this might have on the structure of the market. Doubts have long been raised within the industry as to whether the high number of CCPs currently established in the EU is sustainable. A future drive towards consolidation in certain asset classes cannot be ruled out – although, like most market-driven dynamics, it is difficult to predict what exactly will happen in the future. Enhanced competition in the FMI sector can deliver lower costs and more efficiency for end users and the real economy.

It is sometimes argued that excessive competition among CCPs can have short-term destabilising effects by undermining their ability to build up resilience and risk management capacity. This argument is however not consistent with the expectation which underlies current regulatory thinking that social benefits, such as innovation and incentives for sound risk management, will arise from CCPs remaining for-profit entities. That said, authorities and market participants will need to closely monitor market dynamics and ensure they do not lead to adverse consequences in terms of financial stability, such as a "race to the bottom" over risk management standards.

Third, I believe we need to ask ourselves ***why EU CCPs have not been more active in developing interoperability arrangements***.

The EMIR provisions were designed in part to incentivise the establishment of interoperability arrangements, yet no new links have been established since the entry into force of the Regulation. This is a somewhat surprising development when one considers the obvious efficiency gains that interoperability brings to participants as well as to CCPs themselves. I can think of several potential explanations for this state of affairs. First, clearing members may not yet have fully grasped the potential benefits they would reap from widespread CCP interoperability: as I mentioned in the introduction, interoperability is a relatively new phenomenon in the CCP landscape, and it may take some years for market participants to seize all that EMIR has to offer in terms of incentivising interoperability. Another possible explanation could be that EU CCPs are still "processing" the implementation of EMIR: over the last two years, they have been required to go through a comprehensive authorisation phase, and have had to adapt to a demanding new regulatory environment. We may see an uptake in the establishment of interoperability arrangements now that these regulatory hurdles have been cleared. I hope that the feedback received from market participants today will help us answer this question.

One final question which comes to mind is ***whether systemic risk is adequately addressed in the current regulatory framework regarding interoperability***.

As I mentioned above, the collegial process established under EMIR ensures that multiple regulatory perspectives are captured within the cooperative supervisory framework. Some of the authorities involved in the supervision of interoperability arrangements bring a clear systemic risk perspective – this is namely the case for the central banks of issue of the most significant currencies cleared. Therefore, systemic risk concerns are by no means overlooked in the supervisory process, as it now stands. However, on certain specific aspects, the role of macro-prudential authorities could be further enhanced. The ESRB's forthcoming report to the Commission on the systemic risk implications of interoperability arrangements will certainly make some relevant proposals in this regard. To inform this work, data availability will be of the essence. Besides the transparency provided by the new CPMI-IOSCO public quantitative disclosure standards, the joint analytical work recently started by the FSB, BCBS and CPMI-IOSCO on CCP interdependency will shed more light on cross-exposures and contagion channels between CCPs and their clearing members, including potentially through interoperability. Understanding the multiple interdependencies between CCPs and their participants will be an important factor in designing appropriate crisis management and resolution mechanisms, including for interoperability. Going forward, trade repository data collected under EMIR may be another important source of information for authorities, and may help shed light on certain industry dynamics, such as the extent of cross-CCP participation in various asset classes, and the scope for expanding interoperability.

Allow me to say a few words in conclusion. I have tried to present some of the benefits and challenges I would see from the continuing implementation of CCP interoperability. Since the early days of the Giovanni Group, authorities have kept their focus on financial markets integration, but at the same time they have given increasing attention to financial stability concerns. CCP interoperability can play an important role to foster the first objective. Nonetheless, we should not underestimate the complexity and the potential risks involved in establishing and supervising interoperability arrangements, particularly if interoperability spreads to new asset classes in future. I am confident that the collective supervisory process established under EMIR, which allows all relevant authorities to contribute to the monitoring of risks, can meet these challenges.

The ongoing EMIR review process, as well as the upcoming report on the systemic risk and cost implications of interoperability arrangements, to be delivered by the Commission to the European Parliament and Council, will provide us with an opportunity to discuss these issues and think about potential enhancements to the current regulatory framework. The ECB and the Eurosystem look forward to contributing to these discussions.