Yves Mersch: Evolving regulatory environment for CCPs - the perspective of a central bank

Speaking points by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Cumberland Lodge Financial Services Summit, Cumberland Lodge, Windsor, Great Park, 10 November 2017.

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Introduction

I am delighted to return to this year's Summit.

I spoke last year about the systemic importance of central counterparties, and their importance, in particular for monetary policy transmission. I spoke about how the growth of these infrastructures means that the existing regulatory framework will need to be enhanced, to address the increasing risks posed by CCPs.

I also spoke of how the prospect of the UK's exit from the EU creates uncertainty regarding the future of the regulatory and supervisory framework for non-euro area CCPs that clear significant amounts of euro currency.

There have been very significant developments at EU level since I spoke about this topic last year.

The most notable development has been the Commission's proposal from June of this year to amend the EMIR framework for the supervision and regulation of EU and third country CCPs.

We strongly welcome the proposals to strengthen the role played by the central banks of issue of the EU in the regulatory framework, as the authorities responsible for the implementation of monetary policy. This strengthening is necessary in light of two major trends of the past few years.

First, since EMIR first entered into force there has been a continued growth of central clearing and resulting financial risk concentration in CCPs. This has significantly increased the potential disruptive effects that CCPs can have on the implementation of our monetary policy.

Second, the UK departure from the EU implies that a very large part of euro-denominated clearing activities across all asset classes may be performed from outside the EU in the future. While central clearing is undeniably a global industry, the range of euro-denominated asset cleared outside of its monetary zone is unparalleled for any other major currency around the world. This clearly points to the need to strengthen the EU regime for third country CCPs and to enhance in this context also the role of the relevant central banks of issue.

As distinct from the need to strengthen the role of the central banks of issue serving a monetary policy purpose, it is also fully justified to seek to strengthen the supervisory regime for CCPs Take the case of third country CCPs: until now, the EU's approach towards third country CCPs, including those that are of systemic importance, has been to rely entirely on the supervision carried out by home authorities. Deference to home authorities should continue to be the norm in those areas where rules are fully equivalent. However, there are certain areas in which EU rules provide more protection than those in other jurisdictions, and in these areas the Commission is right to suggest that reliance on home authorities may not be enough, and that more direct involvement by EU authorities is required. This is the same approach as currently followed by certain other major jurisdictions.

Where the approach proposed by the Commission may differ is that it also foresees that under extreme circumstances, certain systemically important third country CCPs might not be authorised to operate from outside the EU, and would be required to establish themselves within the Union if they wish to continue providing services to EU counterparties and markets. EU authorities acknowledge that such a decision would have important consequences on market structure. However, as I mentioned earlier, for no other major currency are so many systemic asset classes cleared outside of its own monetary area. The requirement, proposed by the Commission, for CCPs to be established within the EU would function as a last resort measure, to be triggered in the event EU authorities cannot control the risks to their mandates through other means. The ECB would be involved in the process in order to share its liquidity considerations as a monetary policy authority, but the final supervisory decision would be within the hands of the Commission and the Union legislators.

Another aspect where the proposals might differ somewhat from the approach taken in certain other major jurisdictions is the larger role given to central banks of issue. In this respect, it should be noted that a comparable role has been given to the US Federal Reserve in respect of systemically important financial market utilities, including CCPs. This is entirely justified: enhancing the role of central banks is absolutely essential considering just how critical CCPs have become for the smooth conduct of monetary policy.

Indeed, disturbances affecting a CCP can cause significant liquidity strains for banks. This can directly affect the central bank’s ability to implement monetary policy and can impact the smooth functioning of payment systems.

In addition, a crisis affecting a repo CCP can disrupt the functioning of the money market, thereby impairing the channels through which central banks conduct monetary policy operations.

Furthermore, disruptive changes to CCP risk management (e.g. sudden collateral haircuts) can generate asset price volatility and affect the central bank’s ability to implement monetary policy.

Finally, a potential decision to allocate liquidity for financial stability purposes outside the currency area would affect the monetary policy stance of the central bank inside the currency area.

This is the reason why, in the event of a severe crisis, emergency financial assistance by euro area national central banks is always subject to a non-objection procedure by the ECB to preserve its monetary policy objective.

This brief overview shows the significant impact the malfunctioning of a major CCP clearing significant amounts of euro could have on the conduct of monetary policy. At the same time, allow me to stress that the Commission proposal does not entail that central banks of issue would duplicate the work of supervisors. On the contrary, the role ascribed to them is a limited and targeted one, centred on the aspects of CCP risk management that are most essential for the fulfilment of their monetary policy mandates. This is also why third country CCPs and their home authorities need not be concerned about potential overlaps between EU supervisors and central banks: each will play a well-defined role in the regulatory framework, under their respective statutory responsibilities.

In order to play the greater role foreseen for central banks under the legislative proposal, the ECB’s Governing Council unanimously adopted a recommendation to amend Article 22 of our Statute.

I would like to emphasize here that any potential regulatory actions of the ECB could only be taken within the limits ascribed to us by the Treaty – i.e. the implementation of monetary policy – and would be subject to stringent internal governance controls as well as full judicial review. The role that we would fulfil is not a supervisory one – this is the task conferred upon the national competent authorities and ESMA. Our involvement would be fully focused to the specific responsibilities with which we are tasked as a monetary authority.

Likewise, the Union legislators or the Commission could only adopt measures within the limits of their tasks under the Treaties, focusing on the field of CCP supervision, and their objectives of ensuring financial stability and achieving the harmonisation of the internal market. This would be essential to avoid overlapping or contradictory measures. After all, these objectives are distinct but complementary to the objective of price stability.

Further issues regarding FMIs arising from Brexit

The withdrawal of the UK from the EU will, needless to say, create legal uncertainty not only for CCPs but, also, for other financial market infrastructures, including payment and securities settlement systems processing euro-denominated transactions. These issues need to be carefully monitored and assessed, and solutions may need to be explored in order to ensure certainty and stability.

By way of example, the EU's Settlement Finality Directive provides that only payment, clearing and securities settlement systems governed by the law of an EU Member State may be 'designated' by Member States, and only such 'designated' systems may benefit from the finality protections under the SFD. Systems governed by the law of a third country are not eligible for designation under the SFD, and will not benefit from those protections. As a result, if EU participants in a third country system were to become insolvent, the courts could, based on their national insolvency laws, and depending on whether or not their national legislator has activated the option provided for in Recital 7 of the SFD, require the unwinding of transfer orders that they have entered into the third country system, thereby undermining the system's integrity and affecting other participants in that system. Regulatory accommodations may need to be made, to mitigate the adverse effects of the loss of SFD designation. However, it remains to be seen whether this will prove possible and, if so, what form these will assume.

Another example relates to issues arising with regard to the proposed moratorium tool under the BRRD. The recent proposal to amend the BRRD, empowers competent and resolution authorities to suspend certain payments and delivery obligations, if this would help facilitate recovery and resolution. Of course, the proposal ensures exemptions from the moratorium tool related to FMIs, including CCPs. It may be necessary to consider whether there is a need to exempt recognise third-country central securities depositories and third-country payment systems subject to a cooperative oversight arrangement involving at least one central bank in of the ESCB.

The rationale is that a suspension prohibiting a participant (e.g. a credit institution) from making any payments to an FMI will de facto cause that participant to no longer be able to meet its obligations as they fall due. For payment obligations to FMIs, this would place the participant in default. Without an exemption for this type of payment, the moratorium would actually have the potential to amplify systemic risk before the FMI safeguards kick in.

Conclusion

I have a few concluding remarks.

First, these various legislative initiatives are crucially important in the current context. Ensuring a successful outcome of these discussions in a timely manner should be a key priority for EU legislators.

Second, we strongly welcome the intention of the legislator to give central banks of issue a role in the regulatory framework for CCPs, commensurate with their responsibilities. As I have said, this is of crucial importance, considering the fundamental impact CCPs can have on monetary policy. At the same time, the involvement of the central bank in the regulatory framework should not put into question either its independence or its discretion to define the scope of its monetary policy. We are confident that the EU legislator will fully recognise this imperative.

Thank you for your attention.