# Yves Mersch: Euro clearing - the open race

Keynote speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Frankfurt Finance Summit, Frankfurt am Main, 29 May 2018.

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During the 2008 financial crisis, counterparty risks became infamous. Obviously, every finance textbook deals with the risk that, when you enter into a financial contract, the other party may not fulfil their part of the agreement and may even default on their obligation. But the failure of Lehman Brothers and the large losses suffered by AIG in over-the-counter derivatives markets revealed that there were counterparty risks throughout the entire financial system. This was due to the domino effect of counterparty defaults in leveraged products.

As a response, G20 leaders agreed at the 2009 summit in Pittsburgh to move all standardised derivatives contracts to clearing through central counterparties (or CCPs). CCPs address the weaknesses exposed during the crisis by insulating counterparties from each other's default risk. They specialise in managing counterparty credit risk, and by doing so they reduce the risk of defaults spreading across the financial system.

But CCPs can only make the financial system safer if they are safe themselves. In the European Union, they are subject to a comprehensive regulatory framework. The European Market Infrastructure Regulation (or EMIR) ensures that they hold robust resources to deal with financial distress. And it introduces a cooperative approach to CCP supervision, involving all relevant supervisors and central banks in "supervisory colleges" to ensure that CCPs are properly overseen across Member States.

The global regulatory push towards central clearing has contributed to making CCPs extremely important parts of the global financial system. In 2009, just 40% of all interest rate derivatives contracts were cleared through CCPs, but by 2017 this had increased to 83%[1].

## New developments and current challenges

The rising importance of CCPs means that their supervisory framework needs to be reformed. Most clearing is now done across borders and is strongly concentrated in a limited number of EU CCPs, which have become systemically important for the EU as a whole.

Two of these CCPs are based in the United Kingdom. Currently, they clear around 95% of euro-denominated interest rate derivatives and around 30% of euro-denominated repos. Thus, a significant disturbance involving a major UK CCP could affect financial stability and market functioning across the EU. On top of this, most of the liquidity provided by central banks tends to be channelled through the repo market.

The United Kingdom's withdrawal from the EU means the supervisory framework for non-EU countries must be adapted. EU authorities must continue to be able to not only closely monitor UK CCPs but ensure they comply with EU regulations.

### *The importance of central clearing for central banks and their monetary policy mandate*

So precautions have to be taken to ensure that CCPs do not become a weak point for monetary policy and the currencies issued by central banks. CCPs can pose significant risks to the smooth operation of payment systems and to monetary policy transmission in times of market stress. Let me give you some examples.

Market volatility or failures in CCPs' risk management may affect liquidity within the financial system and that of CCP users, who are typically monetary policy counterparties and key participants in payment systems. In extreme situations, liquidity shortfalls could foster contagion and lead to CCPs and banks becoming distressed. This could mean the ECB needs to provide liquidity to systemic CCPs or to their members to ensure that payment systems continue to function smoothly and that monetary policy can be transmitted effectively. It is clear that, in such cases, liability and control need to be well aligned: the ECB must be able to monitor and control the risks posed by CCPs.

CCPs are also directly relevant for payment systems. Cleared markets represent a significant share of financial markets as a whole, meaning that CCPs are settling large payment volumes. In order to ensure that payment systems continue to function smoothly, the ECB must ensure that CCPs have appropriate arrangements in place for liquidity management and settlement in euro.

Moreover, in the past CCPs have increased margins and collateral haircuts beyond the levels required by prudential standards or their own risk models. But doing so they may cause liquidity strains and increase volatility in bond prices which, in turn, affects the transmission of monetary policy. To be clear, CCPs should of course make sure they remain resilient to liquidity risks. But they should do so in a predictable manner and based on sound risk models that should not undercut monetary policy decisions.

## Recent regulatory reforms

These challenges were widely recognised when, in June of last year, the European Commission proposed amending the EMIR framework for the supervision and regulation of CCPs.

The Commission acknowledges the essential role played by central banks of issue (or CBIs) in monitoring and addressing risks posed by CCPs to their currency, and has proposed an enhanced and binding role for CBIs under the EMIR framework.

This would mean that central banks would become non-voting members in the European Securities and Markets Authority (ESMA) structure responsible for CCPs. ESMA aims to improve the functioning of financial markets in Europe by strengthening investor protection and cooperation between national competent authorities.

The enhanced role for central banks would tend to avoid harmful mismatches between prudential decisions and monetary policy. And it would grant central banks a flexible and effective role in determining the conditions under which CCPs that are not located in an EU Member State are allowed to provide services in the EU.

I welcome the proposal to strengthen the role of CBIs. It would reinforce coordinated supervision, while reflecting the responsibilities of the ECB – as a CBI – within the supervisory framework.

## The role of the central bank of issue

### *Background and rationale for the ECB recommendation*

However, although EU legislators can incorporate a role for CBIs into the processes for supervising CCPs, the regulation cannot go so far as to *confer* on the ECB the sort of binding instruments this enhanced role requires, which the ECB thought it had until challenged in court by the United Kingdom.

In 2015, the General Court held that the ECB does not have the competence to regulate the activity of securities clearing systems, including CCPs. Moreover, the Court stated that the ECB would need to request an amendment to Article 22 of the Statute of the ESCB and of the ECB, which already enables the ECB to make regulations for clearing and payment systems, if it considers this necessary for the proper performance of its tasks under the Treaties[2].

The ECB's Governing Council therefore unanimously adopted a recommendation to amend Article 22[3] to extend it to cover derivatives, give legal effect to the ECB's role under EMIR, and give the ECB the flexibility and autonomy to act outside EMIR where clearing would pose a severe threat to the stability of the euro.

### *Amending Article 22 of the Statute – procedure*

Let me briefly explain the procedure for amending the Statute.

The Statute is found in a Protocol to the EU Treaties. Such protocols form an integral part of the Treaties. This means that, in principle, the Statute can only be amended as part of a revision of the Treaties.

However, some provisions of the Statute – like Article 22 – can be amended by means of a "simplified amendment procedure". The ECB can recommend a change; the Commission can give its opinion; and the Council and European Parliament can then adopt a decision to amend the Statute by simple majority.

Given that the simplified amendment procedure is an exception, we have to be very careful *what* we change in Article 22 and *how* we go about changing it. Any change must comply with the other provisions and principles of the Treaties, which enjoy a higher constitutional rank. For example, any change to Article 22 must respect the principle of central bank independence and the exclusive competence of the ECB to conduct monetary policy.

### *Amending Article 22 of the Statute – substance*

But what does this mean for the substance of Article 22, which is part of Chapter IV of the Statute, entitled "Monetary functions and operations of the ESCB"?

The Statute grants the ECB flexibility and autonomy over the instruments available for conducting monetary policy. The Treaty drafters provided for various instruments[4], including the possibility to conduct open market and credit operations, and to make regulations to ensure efficient and sound payment and clearing systems.

This means that the ECB can react effectively to unforeseen circumstances. For example, the ECB was able to take the unconventional monetary policy measures it saw fit to address unprecedented economic developments – and thus to achieve its primary objective of maintaining price stability in the euro area.

This flexibility and autonomy is a clear expression of the principle of central bank independence, and of the Eurosystem's exclusive competence to define and implement monetary policy.

The simplified amendment procedure does not give us carte blanche to rewrite the Treaties and the principles that underpin the ECB and the Eurosystem. Rather, it allows us to make targeted adjustments to our monetary policy toolkit.

I have three things in mind here.

First, Article 22 should not be changed to contain an inflexible and exhaustive list of measures the ECB can take. This would constrain monetary policy. The ECB needs broad discretion to take the necessary measures and address risks to monetary policy and the smooth operation of payment systems. Extreme market events are impossible to predict and central banks have the unique expertise and exclusive competence to assess and address the risks they pose to monetary policy.

Second, Article 22 cannot subordinate ECB measures to the level of secondary Union law, for example by requiring them to be consistent with secondary legislation. This would create a hierarchy of internal market legislation over monetary policy measures. This cannot happen. We cannot open a Pandora's box and end up in a situation where monetary policy is no longer shielded against political influence. Moreover, any such subordination would imply that the objective of the Internal Market is superior to the objective of Economic and Monetary Union. This is not the case; these are equal and complementary objectives of the European Union. Moreover, as the ECJ made clear in the Pringle case, "[…] each institution of the Union is to act within the limits of the powers conferred on it in the Treaties, and in conformity with the procedures, conditions and objectives set out in them."[5]

And third, there is a limitation: Article 22 cannot confer general regulatory competences on the ECB – it can only adjust the ECB's monetary policy toolkit by clarifying that the competence for clearing and payments covers derivatives. The Treaty drafters made the ECB's objectives and tasks very clear. As the European Court of Justice said, a measure falls under the responsibility of the ECB when it is intended to pursue an objective such as the consistency of monetary policy or the proper transmission of monetary policy. This objective, in turn, contributes to the primary monetary policy objective of maintaining price stability[6]. The reason why monetary policy needs to cover CCPs' liquidity is that derivatives clearing has become a cornerstone of the financial system.

We must not forget that ECB measures must also comply with the principle of proportionality. This means that any ECB actions in the field of clearing will have to be appropriate for attaining monetary policy objectives and cannot go beyond what is necessary to achieve those objectives. And it goes without saying that the ECB will not be acting in a legal vacuum – in considering the proportionality of its actions, it will have to take into account existing secondary law and justify any measures it takes. And the Court of Justice would be the ultimate arbiter to determine whether the ECB is respecting the principle of proportionality.

## Conclusion

Let me conclude.

It has become evident that disturbances affecting CCPs can have an impact on monetary policy, on payment systems and, ultimately, on price stability. The Commission's proposal to amend the EMIR framework is a step in the right direction as it reflects the responsibilities of the ECB – as a central bank of issue – in the supervisory framework.

However, we also need to adjust the ECB's monetary policy toolkit to ensure it can fulfil its role. This requires amending Article 22 of the Statute in a manner that respects the principle of central bank independence and the ECB's exclusive competence for monetary policy. Moreover, any change to Article 22 must preserve the ECB's flexibility and autonomy to react to unforeseen circumstances and effectively address risks to its mandate.

Ultimately, amending both EMIR and Article 22 will establish a comprehensive legal framework to address the risks CCPs pose to the Union – both its financial markets and its currency. It will ensure that the EU's legislators, supervisors and central bank – acting in their respective roles – can adopt the wide range of measures needed to safeguard stability.

Let's make sure we don't waste this opportunity.

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[1] Notional value outstanding; see: www.bis.org/statistics/d7.pdf.

[2] See Judgment of the General Court (Fourth Chamber) of 4 March 2015, United Kingdom of Great Britain and Northern Ireland v European Central Bank (ECB), Case T-496/11.

[3] See www.ecb.europa.eu/ecb/legal/pdf/oj_joc_2017_212_r_0004_en_txt.pdf

[4] Listed in Chapter IV of the Statute.

[5] See Judgment of the European Court of Justice, §153 in case C 370/12 (Pringle case).

[6] See Judgment of the Court (Grand Chamber) of 16 June 2015, Peter Gauweiler and Others v Deutscher Bundestag, Case C-62/14.