EFAMA
European Fund and Asset Management Association

POSITION PAPER

Brussels, 01 June 2023

DETAILED VIEWS ON ACTIVE ACCOUNTS (EMIR 3.0)

This paper provides an in-depth analysis of the impact of active accounts on clearing markets as proposed under the European Commission's review of EMIR 'EMIR 3.0'. This paper accompanies the earlier EFAMA position on EMIR 3.0 and seeks to provide a quantitative analysis on the various impacts identified.

The paper is divided into 6 sections:

Contents

I. Financial Stability Risks 2
1. Key Principles of Central Clearing 2
2. Coronavirus Pandemic Procyclicality Impacts 4
II. Costs to End Investor 5
1. Discrimination of end-clients 5
2. Margin analysis 5
3. Cost Analysis at Firm Level 7
III. Organic Growth on Eurex 7
Initial Margin for IRS 8
Market Share of EUR iTraxx 9
IV. Measures to enhance EU CCP attractiveness 9
V. Expansion of ESMA's Supervisory and Crisis Management Toolbox 9
VI. EFAMA Recommendations on Euroclearing reform: 10

I. Financial Stability Risks

ESMA produced a report in December 2021 assessing the UK tier-2 central counterparties (CCPs) for 'substantial systemic importance'.

Under the ESMA report on EMIR 25 (2c). ,it is not possible to view the full analysis carried out by ESMA as major parts are redacted but going by the various scenarios that are identified, we have to ask whether strengthened supervisory cooperation between supervisors and central banks should not ,at the very least, be a parallel priority to reducing exposures, and whether artificially fragmented liquidity would not actually introduce greater financial stability risks. The ESMA analysis cannot be relied on as it does not take account of the impact of active accounts. The EC itself has not provided an impact assessment to quantify the stability risk impacts of active accounts. Our reasoning rests on a number of considerations:

1. Key Principles of Central Clearing

Central clearing's main aim is to promote financial stability by reducing counterparty credit risk and operational risk by offering a trading party an exposure to the CCP rather than a counterparty. This concentration of credit risk means that CCP's have become systematically important and subject to increased focus on their ability to manage risk. Clearing functions well if a CCP has strong clearing members that contribute to its default fund, there is access to liquid and efficient markets, the market participants are diverse from many different jurisdictions and the CCP has a standardized process for managing defaults in the event of the insolvency of a market participant.

We believe that EMIR 3.0 may lead to undesired consequences, including artificially created pool(s) of liquidity on an EU CCP which would undermine the afore mentioned mechanics of central clearing. One of the concerns is that there would be a far greater concentration of one-directional positions on the EU CCP, which will be exacerbated by the end of the Pension Fund exemption. This impact alone will widen the [difference in] basis [points] between LCH-EUREX, with the latter clearing positions that are similar in tenor and currency, making it harder to attract the other side of the trade which would result in a wider spread of the bid-ask prices between CCP margin requirements. We expect this widening of bid-ask spreads to be most acutely felt on the shorter tenors. Clients and their asset managers would need to consider the basis [point] (difference in rates for the same swap transactions cleared at two different CCPs) and be able to access the best rates for a particular transaction knowing that in a period of market stress, liquidity risk would be heightened for EU CCP clients, as they face greater margin calls.

It is also important to note that currently – more than 70% of the EUR swaps are traded by non-EU market participants. As EUR bonds become more interesting to foreign investors and less costly in terms of foreign currency – we should see this figure and as a consequence the spread between LCH and Eurex increase. We hence believe that the proposal in its current form would undermine potential positive effects for EUR market participants of the currency becoming more attractive to foreign investors (as demand and offer "would not meet" given that the EU CCP liquidity pool only draws predominantly EU-based funds and clients).

Looking at current spread prices– it seems that these two scenarios are actually already reflected in the data.

EUR EUREX LCH SPRD 5Y - Last Price 1.1500
EUR EUREX LCH SPRD 30Y - Last Price 1.6000
EUR EUREX LCH SPRD 10Y - Last Price 3.5000
EUR EUREX LCH SPRD 20Y - Last Price 2.1000
4.0000
3.5000
3.0000
2.1000
1.6000
1.1500
1.0000
0.0000
-1.0000
-2.0000
Dec
Mar
Jun
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2018
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2020
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EULCEX5 Curncy (EUR EUREX LCH SPRD 5Y) Eurex LCH Daily 01JAN2018-22MAY2023
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Furthermore, we note that Eurex has increased their fees over non-cash collateral in the last year. This is a disadvantage for Eurex compared to non-EU CCPs given that pension fund clients mainly hold assets on their balance sheet (rather than cash) and require the option to post and receive non-cash collateral for the purpose of their derivative transactions.

On 23rd March 2023, Risk.net published an article highlighting that the basis [point differential] between LCH and Eurex had widened to 4 basis point (bp) on Euro 10 Yr IRS contracts. This implies a growing imbalance in flows at Eurex between payer and receiver swaps and in our view, could result in significant and unpredictable costs for EU entities forced to clear a proportion of their contracts within the EU as a result of the EMIR 3.0 proposal. An even bigger concern is volatility in this basis over time making it difficult for EU entities to quantify until such time as a requirement to use the EU active account is triggered subject to 'as yet undefined' ESMA rules.

> For example, an EU entity clearing a €10m 10 Yr interest rate swap (IRS) at Eurex which has interest rate sensitivity (PV01) of €10,000 would be subject to a €10,000 per bp difference in pricing for clearing that swap between LCH and Eurex. That means that with a 4 bp difference in basis, there would be a €40,000 difference in price between LCH and Eurex. For directional activity (e.g. pension fund LDI activity) this would increase or decrease proportionally with the size of those positions.

In practice, the widening basis [point differential] between IRS cleared at two CCP's suggests there is a bias towards payer or receiver swaps in a particular tenor resulting in higher margin costs. It is therefore important to understand what if any further impact the end of the pension fund exemption in the EU is going to have on stabilising or potentially further destabilising the LCH-Eurex basis before any decision is taken on active accounts.

2. Coronavirus Pandemic Procyclicality Impacts

In June 2021, EFAMA members presented at an ESMA Procyclicality workshop. As part of that presentation, members highlighted the procyclicality experienced across global CCPs providing clearing for OTC interest rate derivatives.

This highlighted significantly procyclical margin impacts at certain CCPs where initial margin (IM) balances rose rapidly between 31 December 2019 and 31 March 2020. During this period, based on analysis undertaken by ClarusFT for a Risk.net article (Swaps data: initial margin soars in Q1 2020) the change in risk positions alone was insufficient to explain the significant change in IM. The analysis by ClarusFT highlighted the quantum of those changes and the degree of procyclicality in CCP margin models at a range of global CCPs. The analysis highlighted that procyclicality at that point in time was highest at JSCC, CME and Eurex with LCH being the least procyclical. Whilst EFAMA members are aware of subsequent changes to the Eurex methodology to reduce procyclicality, the increase in (IM) demands is also an important consideration for EFAMA members in determining where to clear on behalf of clients, especially in the context of a potential active account requirement following EMIR 3.0. At the ESMA workshop, EFAMA members also expressed their support for more transparency and stability in CCP IM models, Nevertheless, EFAMA members are concerned about potential future procyclical margin risk at EU CCPs.

The changes in IM between 31 December 2019 and 31 March 2020 are outlined in percentage and absolute terms below:

CME, JSCC and Eurex's IM increased far more significantly during early stages of the pandemic than LCH's models.

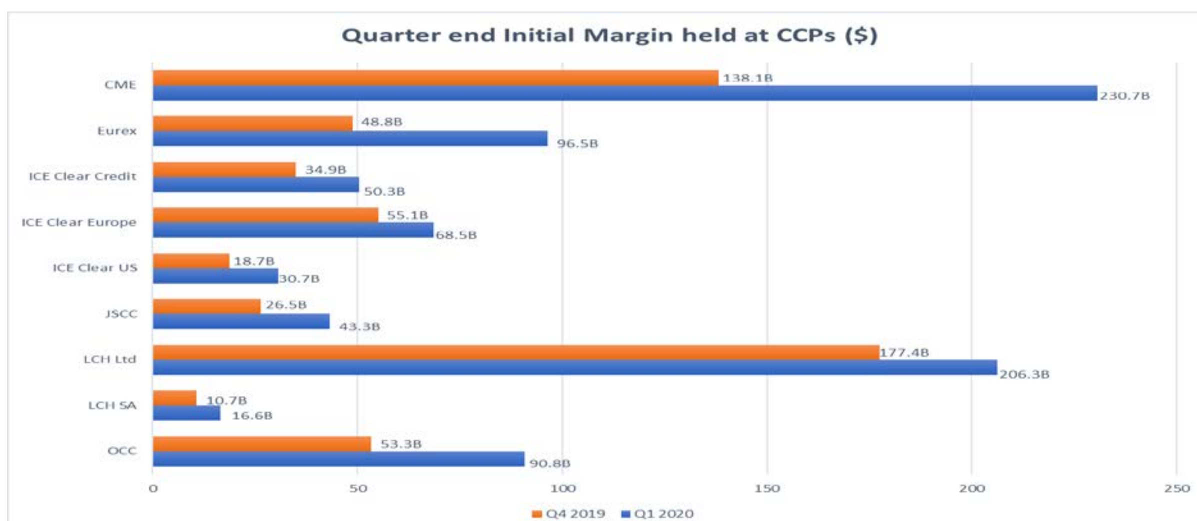
Eurex IRS – up 61% between 31 Dec 2019 – 31 Mar 2020.

JSCC IRS – up 45% between 31 Dec 2019 – 31 Mar 2020.

CME IRS - up 38% between 31 Dec 2019 – 31 Mar 2020.

LCH IRS – up 16.5% between 31 Dec 2019 – 31 Mar 2020.

(Source : Risk.net : 8 Jul 2020 article : Swaps data: initial margin soars in Q1 2020)



Source: Public Quantitative Disclosures, FIA CCP Tracker

Note: LCH LTD and LCH SA data include only initial margin for cleared derivatives

II. Costs to End Investor

1. Discrimination of end-clients

One major unintended consequence of the envisaged active account requirement under EMIR 3.0 will be that asset managers will effectively discriminate between clients entering into similar contracts and positions, where those that are clearing voluntarily and not subject to the clearing obligation will receive one price, whereas those that are subject to the clearing obligation and therefore the thresholds will be limited only to the prices on offer at the EU CCP. There should not be a difference between clients on the best clearing rate that asset managers can access on their behalf for the same transaction. This outcome clearly runs counter to the principle of best execution in Europe. Over time this undermines the competitiveness of European firms and also deters new clients and funds from wishing to set themselves up in the EU.

For firms already set up in the EU, it is likely to discourage use of derivatives for hedging and efficient portfolio management. This will make these product less appealing and competitive versus their non-EU equivalents.

2. Margin analysis

We created various portfolio compositions using the LCH and Eurex margin simulation tools

Case Study 1: EU Fund or Account which is a large Financial Counterparty trading multi-currency Interest Rates Swaps (payer & receiver swaps) & EUR Fixed Income Futures

Swap analysis

- One margin call at LCH with all currency swaps netted = approximately 2.5mn saving
- Approximate 2mn increase in margin requirement when the EUR IRS swaps are cleared separately at Eurex, whilst all other IRS currencies continue to clear at LCH.
- Margin requirement for the non-EUR swap book at LCH also increases by 1mn highlighting the significant savings that cross-currency netting can achieve.

Cross-product margin between EUR IRS & EUR FI Futures

- We added a mix of EUR FI ETD positions to the portfolio (already cleared at Eurex).
- The cross margin for EUR ETD & EUR IRS incurred an approximate 2% saving (~24k) in the EUR IRS margin requirement, this is a negligible margin saving when compared to the 2mn saving through multi-currency netting efficiencies.

Case Study 2: EUR pension fund trading EUR Interest Rate Swaps (payer & receiver swaps), EUR inflation-linked swaps, EUR FI ETD

Swap analysis

- One margin call at LCH for interest rate swaps & inflation swaps = 200mn margin saving.
- Moving the EUR IRS book to Eurex, the portfolio loses netting efficiencies and pays two separate margin calls that are approximately 225mn higher compared to the whole portfolio cleared at LCH.
- The portfolio benefitted from significant netting efficiencies between interest rate and inflation linked swaps.

Cross-product margin between EUR IRS & EUR FI Futures

- We added a mix of EUR FI ETD positions to the portfolio (already cleared at Eurex).
- The cross margin for EUR ETD & EUR IRS incurred a 15% saving.
- Whilst this reduced the IM amount for EUR IRS swaps on a standalone basis at Eurex, two separate margin calls (Eurex for EUR IRS & EUR ETD + LCH for inflation linked swaps) increased margin by 200mn

Case Study 3: EU pension fund trading interest rate swaps (long-dated, directional receive fixed portfolio)

- LCH margin is lower across most tenors. Eurex appears to be lower at 50year Receiver end.

Summary

Deciding which CCP to clear through is not straightforward. There are several considerations, including the Fund or Account investment objective and the fund type, the portfolio's composition, and costs. Cost is an integral part of overall portfolio risk management given the opportunity cost of capital deployment. When calculating the all-in-cost of clearing, besides summing the transaction costs, CCP fees, clearing broker fees, and margin, we also take into account funding implications, as well as, netting efficiencies.

During times of market volatility, CCPs tend to increase margin requirements. Whilst CCP margin calls themselves do not cause market volatility, they could exacerbate volatility by removing market liquidity from the broader system as more collateral shifts from market participants into the CCP. Less market liquidity and reduced market-making opportunities can make it more expensive for end-investors to hedge their positions due to higher margins and increased transaction costs.

3. Cost Analysis at Firm Level

a) Costs of connecting to EU CCPs where accounts do not currently exist per fund:

There is a fixed charge to be paid to clearing brokers for each account held at a CCP. However with the introduction of active accounts, the increase and duplication of workload at the clearing broker will lead to fee increases. On top of that, there will be account and transaction costs at the respective CCPs. This will be particularly costly under the ISA model.

b) Cost of operationalizing the active accounts requirement: calculations, continuous monitoring, margining toward 2 CCPs..

This cost item has multiple dimensions. One is change/one-off costs, this relates to system enhancements in relation to portfolio management, compliance engine/guideline monitoring, order routing and trade execution systems. Further, middle office, settlement, accounting and collateral management/margining processes will have to be amended to cater the new requirements. The change dimensions are: identification and calculation methodology of thresholds on account and transaction basis, automated blocking of CCPs for concerned accounts, new methodology for trade aggregation used for block trading, some type of identifier re/ best execution/market conformity checks,…For buy-side firms this will involve changes to software and discussions with vendors, costs will be >EUR 500k. In addition, the b.m. will likely lead to increased ongoing costs in terms of license fee and similar, but also re/ transaction costs on execution, margining (being charged by the custodian and in addition by the clearing broker),…

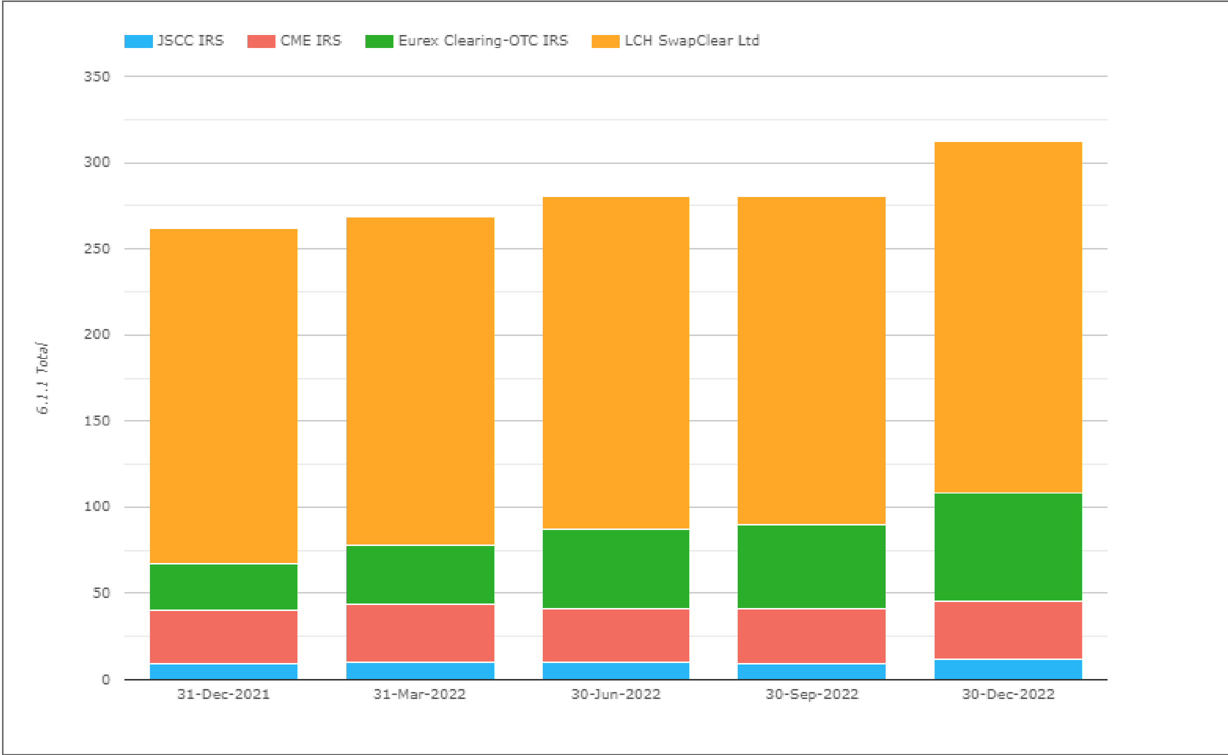
III. Organic Growth on Eurex

The CPMI-IOSCO Public Quantitative Disclosures report includes quantitative data on initial margin figures. As the initial margin figures are derived from the cleared derivatives volume, the figure could be used to show trends in clearing.

Based on the IOSCO data (compiled and put into graphs by Clarus), one can see that the clearing volume of IRS at EUREX (measured by initial margin volume) increased by 152% from Q4/2021 to Q4/2022, while it remained rather stable at LCH. In fact, the majority of the clearing volume increase is attributable to EUREX (USD 37bn of USD 51bn).

Also for the CDS EUR iTraxx series, there is a continuous increase of clearing volumes by Paris-based LCH SA. Considering that ICE Clear Europe will exit the European clearing landscape, one can expect a good part of this volume to go to LCH SA as well throughout 2023.

Initial Margin for IRS

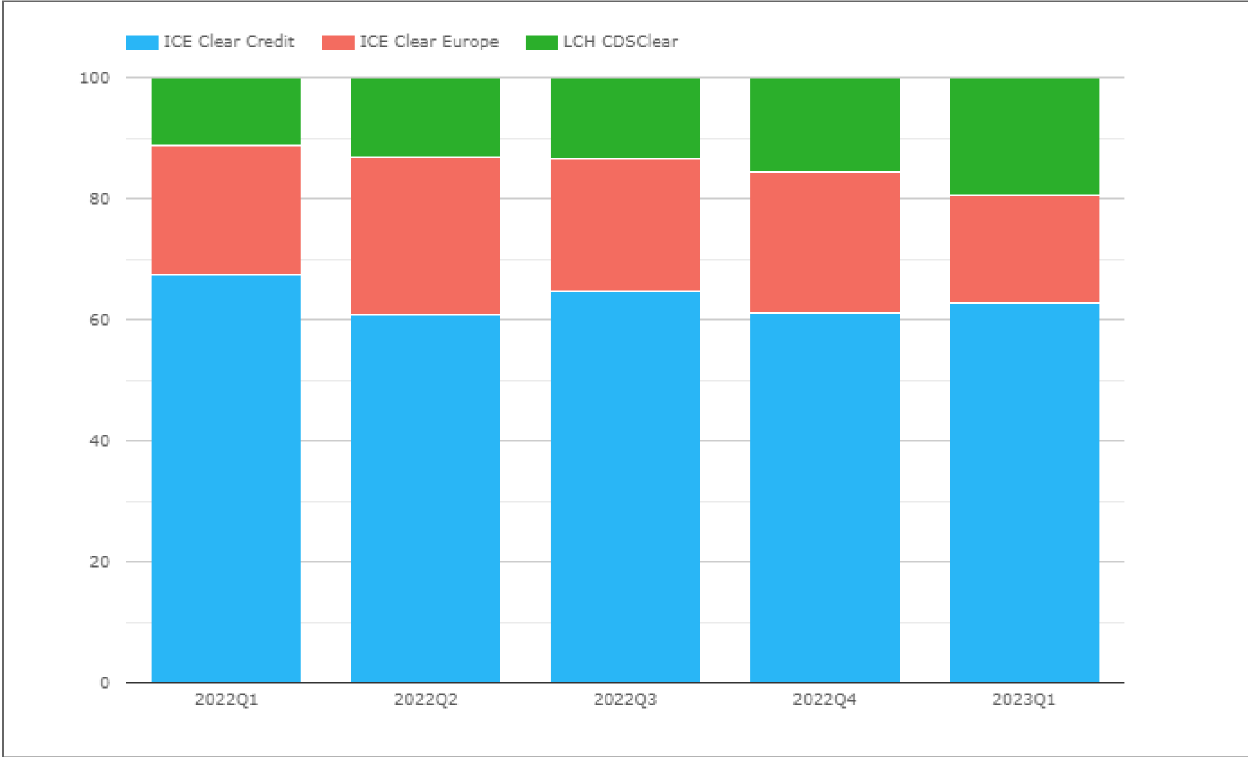


IM at major IRS CCPs (usd billions)

- Total IM for these four CCPs was $312 billion on 30-Dec-2022
- Up $31 billion or 11% QoQ and $51 billion or 19% higher YoY
- LCH SwapClear with $204 billion or £169 billion on 30-Dec-2022
- Down 2% QoQ and Up 17% YoY in GBP terms (Up 7% and 5% in USD terms)
- Eurex OTC IRS with $63 billion or €59 billion
- Up €9 billion or 17% QoQ and €36 billion or 152% YoY (in EUR terms)
- CME IRS with $33 billion, up 1% QoQ and up 7% YoY

Eurex OTC IRS IM increasing $37 billion YoY is responsible for the majority of the $51 billion increase.

Market Share of EUR iTraxx



EUR CRD Index market share of CCPs

- ICE Clear Credit with 62.85% in 2023Q1, down from 67.4% in 2022Q1
- LCH CDSClear with 19.4% in 2023Q1, up from 11.2% in 2022Q1
- ICE Clear Europe with 17.7% in 2023Q1, down from 21.4% in 2022Q1

IV. Measures to enhance EU CCP attractiveness

To support the move to mandatory clearing at EU CCPs and their competitiveness, EFAMA considers that securities and not only cash should be allowed as collateral for Variation Margin at EU CCPs, to incentivize firms to move to EU CCPs. We consider that **government securities from EU member states** are particularly liquid and could meet the intraday call constraints at CCPs.

Perhaps even more important in the collateral debate is the question of central bank linkage to CCPs. The ability for CCPs to convert highly liquid assets into cash through central bank operations is critical and avoids the firesale of assets.

V. Expansion of ESMA's Supervisory and Crisis Management Toolbox

International supervisory cooperation

The recent banking turmoil involving Silicon Valley Bank and Credit Suisse demonstrated the importance of international supervisory cooperation when managing the failures of major financial institutions . ESMA concluded in its December 2021 report that the EMIR cross-border supervisory framework could be further enhanced. Why are these supervisory measures not explored in the EMIR 3.0 proposal?

In particular, we believe the points below could have very usefully been addressed in the EMIR 3.0 proposal:[1]

iv) ESMA be granted the power to approve recovery plans of Tier 2 CCPs;

v) ESMA be granted the power to request from Tier 2 CCPs (and third country authorities) to be notified prior to imposing any restriction, suspension, or termination of access to EU clearing members;

vi) a new mandate be included in the CCPRRR to provide ESMA with the possibility to negotiate an additional MoU with Tier 2 Third Country authorities on recovery and resolution; and

vii) ESMA be consulted by third country authorities before they adopt, in the context of the resolution of a Tier 2 CCP, any measures that could potentially have an adverse impact on EU market participants.

The combined effect of i) EU approval of Tier-2 CCP recovery and resolution plans, and ii) broader coordination of any discretionary powers that could impact the financial stability of EU member states (i.e margin requirements, haircuts) would effectively address any remaining concerns around systemic risk and misalignment of stability interests in different jurisdictions, while avoiding a relocation policy with known costs (see Section I, above) and unknown stability implications.

VI. EFAMA Recommendations on Euroclearing reform:

- Continue to work on enhancing the attractiveness of EU CCPs, and potentially build out a roadmap together with clients and clearing members. As clearing clients, we observe that Eurex is continuously making its offering more attractive, and this will over time attract more clearing demand from diverse participants, including non-EU clients as it begins to attract portfolios that are diversified from a product/currency standpoint. An industry task force could be set up involving clearing clients, clearing members and Eurex to examine ways that this process could be expedited. This organic and market-based approach would favour healthy and balanced growth at an EU CCP.
- At the same time, the objective of increasing EU CCP clearing should always be coupled with freedom of choice on where to clear. A threshold driven approach will invariably mean that certain clients are disadvantaged over others, accessing worse prices over other fund clients, simply because the asset manager is bound to respect certain thresholds. This introduces unfair treatment and discrimination of the end client, making it very difficult to enforce best execution and should be absolutely avoided..
- Active accounts with thresholds would only grow one-directional clearing volumes on EU CCPs, likely increasing the basis and making it harder to draw international clearing clients in search of competitive spreads, This lop-sided growth will actually damage the ability of EU CCPs to compete internationally.
- We see evidence that Eurex is showing positive market growth as new products/services and incentive schemes are introduced. It would be wise to allow this competitive dynamic to continue unaided by regulation.
- Hold off on any policy change until the pension fund exemption has expired and its impact reflected on the clearing volumes on different CCPs.
- As we know CCPs mitigate credit risk, but they do create liquidity risks as they rely on participants to provide cash. Margin requirements increase with both market volatility and the increased risk of defaulting participants, making CCP liquidity needs inherently procyclical. Active accounts could exacerbate the liquidity risk faced by EU CCPs. It is therefore critical that the EC first conduct an in-

[1] See p 7, esma91-372-1945_redacted_assessment_report_under_article_252c_of_emir_ukccps_final_1of2.pdf (europa.eu)

depth impact assessment as a complement to the ESMA 2021 art. 25c assessment, including in the stress test scenarios:

- liquidity risks, and the evolution of overall basis and margin movements in times of stress.
- How two separate liquidity pools, with an uneven split (70%:30% on eurodenominated IRS), might behave in times of stress given two separate supervisory frameworks and potential for uncoordinated policy choices. The analysis should reflect the fact that the smaller pool of liquidity will have a much higher concentration of one-directional positions.

- The shared oversight of systemically important CCPs should be explored further as per the ESMA recommendations. As the ESMA December 2021 report identified, there is scope for further enhancement of supervisory cooperation and in particular in a period of crisis the ability to coordinate intervention measures to ensure that cross-border financial stability impacts are considered.

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages over EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

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