Financial stability vs jurisdictional competition: the struggle over the common regulation and supervision of CCPs in the Eurozone and beyond

Matthias Thiemann (Sciences Po, Paris)

Central Clearing Counterparties have seen their business volume rise substantially in the last decade. Their rise has largely been brought about by regulatory changes after the financial crisis, which based on the crisis experience following the default of Lehman installed mandatory clearing for the majority of OTC derivatives, first in the US (Dodd-Frank Act) and following that in jurisdictions world-wide. In this way, authorities were seeking to address the problem of interconnectedness and the opacity of bilateral over the counter derivatives, forcing financial market agents instead to enter into trades with CCPs, which had to ensure that these contracts could be fulfilled even if one of the two trading partners were to default in the meantime, taking in collateral to assure this function. Yet, this decision has not been without its own problems.

This paper argues that by deciding to maintain the private status of these critical financial market infrastructures, the global community has however ignored another vital lesson of the financial crisis, namely the danger of jurisdictional competition over shadow banking activities that is based on regulatory costs regarding the amount of risk charges. This factor is important due to the strong resemblance of CCPs to traditional shadow banking activities: it is a high volume, very low margin business (Claessens et al 2013), which is very sensitive to regulatory costs (which in this case involves the setting of initial and variation margining for collateral to be posted by the trading partners). The limited equity in CCPs, again in analogy to shadow banks pre-crisis hence invokes the danger of risk shifting due to the underpricing of risks. The international community sought to address these dangers, driven by regulatory arbitrage activities of CCPs in 2012 through the CPSS-IOSCO Principles for Financial Market Infrastructure, which due to their encompassing nature and the use of the principle of economic substance over legal form do address some of these dangers. Widely deemed as well-crafted and rather strong, these PFMI in turn however invite the risk of supervisory forbearance, where supervisors enforce weaker interpretation of principles based rules to favor their domestic champions.

Aware of these potential problems, recent revisions of the European CCP regulation EMIR, named EMIR 2.0 sought to centralize supervision at the EU level and install a third country supervisory regime, which would have allowed ESMA to correct supervisory behavior and regulatory changes deemed as dangerous to financial stability. Begun in 2017, in the wake of Brexit and the fears of a regulatory and supervisory race to the bottom it reinforced, the Commission proposal contained a strong push for supervisory centralization. The final regulation in spring 2019 achieved only a half-baked compromise, invoking stronger powers for ESMA in a third country regime, while maintaining national supervision within the EU, at least partially defeating the intention of the initial regulation. Based on 20 interviews with different regulatory stakeholders and national competent authorities, this paper traces the evolution of the initiative and the reasons for its final failure. It then evaluates the consequences of the reform, namely third party CCP supervision and the likelihood that due to opposition of the US, using its market share to pressure European regulators, there will possibly be no effect of the entire reform. If this this were to be the case, this would mean maintenance of jurisdictional competition, which invites a competition on lower margins (in case you are short on collateral), in turn endangering financial stability. The paper concludes by evaluating alternatives for dealing with these dangers, by either submitting CCPs to bank-like regulation or by transforming them into public utilities.