Europe’s post-trade sector: Where is Brussels leading us? A high-level dinner discussion on developments in the EU’s post-trade regulatory architecture, with Rogier Wezenbeek (D-G Markt) and others.

Held on Monday, September 5, 2011 at 7:00pm for 7:30pm
At La Maison du Luxembourg, Rue du Luxembourg 37, Brussels 1050

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The dinner was the first Fellowship event to be held outside the UK. Thirty people attended, including senior executives of post-trade infrastructures (CCPs, CSDs and Repositories) and users; regulators past and present; financial attachés from two national representations to the EU; one MEP; a senior end-investor; Commission officials; Brussels-based managers of trade associations representing banks, OTC dealers, exchanges, fund managers and issuers; think tank members and selected journalists, as well as two representatives each of DTCC and the CSFI.

Patrick Pearson, the head of financial markets infrastructure in the Commission’s DG Markt, who was due to introduce the debate, was unable to attend because of illness. However, his colleague Rogier Wezenbeek deputised at short notice and was an able and informative key-note speaker. His introductory remarks kicked off a lively discussion.

The meeting was timed to coincide with the return to work, after the summer break, of the Brussels EU institutions. It took place shortly before the third anniversary of the bankruptcy of Lehman Brothers; at a time when the consequent revision of Post-trade regulation in the EU and elsewhere is proving complex and difficult; and some 15 months ahead of the G20 deadline for putting OTC trades into CCPs. By chance, the meeting took place on the day that a preliminary draft from DG Markt of Commission plans for the revision of the MiFID directive leaked. The discussion was held under the Chatham House Rule, which permits the dissemination of issues raised, without disclosing the identity of the speakers. It ranged over the following themes.

i) The outlook for EMIR (the European Market infrastructure Regulation). The meeting took place with EMIR still having to be agreed by the EU Council of Ministers representing the 27 member states ahead of a final joint decision with the European Parliament. Progress on EMIR is important because it will affect the timing of other legislation in the pipeline, such as a planned proposal from the Commission of a regulation for CSDs. Some of those familiar with the EMIR negotiations were relatively optimistic that a political agreement might be
reached by the Ecofin Council in October under the Polish EU presidency. However, several issues remained to be solved, including whether to exempt pension funds (desired by the Netherlands); “scope”, meaning whether EMIR’s open access provisions on clearing should apply to exchange traded derivatives or only to OTC instruments; the powers of ESMA; central bank liquidity provision; and relations with third countries.

ii) The third country issue raised the question of relations with the US and differences over the extra-territorial impact of the Dodd Frank Act, which is currently being converted into detailed regulation in Washington. Opinions were mixed. Positive assessments of ongoing discussions between EU and US regulators were tempered by warnings that negotiations among regulators would not bind Congress. One participant argued that the US would have to correct deficiencies in Dodd Frank, but this would be delayed (because of Congressional deadlock) until 2013 after the next US presidential election. As a technical corrections bill could pass quite quickly in the US, the EU, with its slower legislative process, could find EMIR taking effect in 2013 just as Dodd Frank was being changed. As a result, Europe could end up with legislation that was strongly influenced by current discussions with US regulators but which differed from that eventually in force in the US.

This could mean the US was heading for a regulatory regime in 2013 that would be arbitragable against Europe. Under one scenario, the US would export risk to Europe and import dollars. However, the same speaker outlined another scenario in which Europe ceased to harmonise EMIR with the US and focused on getting its regulation right. Europe would need to show leadership. But, in so doing, it could prompt Congress to match the EU model. European leadership could also have an impact on clearing in Asia.

iii) The group discussed the possibility of regulation in the EU and US diverting post-trade business to Asia. With policy targeting risk rather than lowering costs and/or increasing efficiency, one participant predicted that EU and US actions would cause business to migrate to Asia. Nearly every major bank was said to be working out how to set up in Singapore and elsewhere. The Asian approach to regulation and risk management was said to be different to that in the West. It was described as less prescriptive, less rule based. It hinged more on the need of individuals to maintain a good reputation. Asian banks were not backed by deposit guarantees and were therefore more careful about their balance sheets. In consequence, the speaker expected much regulatory arbitrage that would benefit Asia. Europe would wake up to the challenge in 4-5 years time after business had moved to Asia.

Another participant reported hearing that several large investment banks were about to shift 25% of portfolios that were booked in London to Singapore. Assets and people were moving in markets that are global. If portfolios are booked in Singapore, the infrastructure will follow.

The participant who reported earlier on US developments spoke of a risk that Asia would exploit differences between the EU and US and export Asian risk to the US. The answer was for Europe to focus of getting regulation right and show leadership to Asia.

iv) There was a lively discussion on competition and access to post-trade infrastructures, fuelled by the disclosure that the leaked DG Markt draft of a revised MiFID regulation strongly encouraged competition and open access along the value chain, including at the level of post trade infrastructures. If eventually agreed and implemented, the MiFID II draft
would fill in gaps left in EMIR and circumvent the European Parliament’s vote earlier this year to limit the scope of EMIR to OTC derivatives clearing.

Although one participant insisted (several times) that vertical silos were in the ascendant and nothing had changed in 10-15 years, this gloomy analysis was challenged by others. One participant pointed to progress in the complex and very risky area of corporate actions in the securities settlement area. The private sector had been able to agree 139 standards covering corporate actions and between 2/3rds and 3/4s were implemented on European markets.

Another pointed to the liberalisation of equities trading through the MiFID I reforms, which, he claimed, had produced €800 million of cost savings on trade side. This was a huge success, reflecting more competition. It created space for rival CCPs, which set new, lower prices. That was good for the buy-side. He added that competition was possible among post-trade infrastructures. India, for example, had two CSDs. It was true that competition was more difficult to secure in the derivatives area. But an opening up of control over the ownership of indices would produce competition and lower prices, he claimed.

Yet another participant pointed out that only a small number of institutions were tenaciously adhering to the vertical silo model and so holding up greater access to post-trade infrastructures. However, there was little support for the suggestion that the current DG Competition investigation into the planned merger of Deutsche Börse and NYSE Euronext would lead to liberalisation in this area.

Among other caveats, there was a recognition that harmonisation was especially difficult. All might agree on the need for harmonisation “at 50,000 feet”. But it was very difficult close to the ground, where peoples’ jobs could be affected.

v) Some argued that greater competition carried the danger of increased risk, especially in CCPs. One participant issued a strong warning against regulatory competition, underlining that CCPs were potentially very dangerous entities. Outlining his fears that CCPs could be a car crash in waiting, this participant suggested that too much risk was being put into clearing houses. There would be dangers if clearing in Europe turned out to be cheaper than in the US. Europe’s CCPs could end up holding a lot of US systemic risk. He said the job of CCPs should be to handle residual risk.

One of the advocates of greater competition among infrastructures argued that cross-border trading needed a level playing field to control risk. In the case of clearing, that meant uniform rules for CCPs and access to CCPs.

Another participant pointed out that there was still unfinished business concerning the regulation of CCPs. The sector was still waiting for details of capital requirements of CCPs and how they would fit with the Basel III bank capital rules and the EU’s capital requirements directive (CRD IV). Also unclear was the issue of CCP resolution in a crisis. These issues had to be clarified before making any assessment of the risks of driving certain financial instruments on to CCPs.

Yet another participant argued that in a mandatory clearing environment, capital requirements relating to bilateral OTC contracts should be risk sensitive and nothing else. They should not be set with the aim of driving certain financial instruments into CCPs.
One speaker suggested that the EU’s practice of tackling post-trade regulation through separate pieces of legislation had led to the original G20 commitment to reduce systemic risk being forgotten.

Another predicted that many of the rules currently being devised would be meaningless, mentioning as an example those that prescribe short term government bonds as good collateral for post-trade infrastructures. If a lot of risk was to be placed in CCPs, they would have to be able to pursue the right policies. This speaker had been told of cases where CCPs had raised margin on sovereign debt and immediately received an aggressive phone call from the national treasury issuing that debt. A car crash would result if CCPs were not given autonomy to assess risk, he warned.

vi) Others, notably end-users, questioned the relevance of clearing for certain businesses and whether the EU’s Post-Trade reforms were fit for purpose.

The meeting was reminded of complaints about the EMIR draft from the Netherlands pension funds, which objected to mandatory clearing and being forced into a one size fits all solution. One participant observed that it had taken 400 years to get well functioning listed markets. Now the EU was trying to regulate world’s largest markets (for OTC derivatives) in 26 months or so. This was irresponsible. It would cost money and increase the risk of pension funds.

A buy-side participant appealed to regulators to look at the impact of their actions on all stakeholders. For example, the increased collateral calls arising from the need to clear more financial instruments would impact the whole economy. These problems were being put to one side. But in 10 years time people would wake up in shock and see what had been done. This was more than a pension fund problem. It affected all end users. This participant argued that the big picture was lost as a result of splitting legislation into smaller bits, such as EMIR, CRD IV, CSDR and MiFID II. In consequence, the tail was wagging the dog, with the infrastructure providers framing the discussion. This participant claimed that she had yet to see one piece of infrastructure or one piece of legislation that was really based on the needs of the users.

Others expressed concern as to whether all the elements of EU post-trade infrastructure legislation would link up together.

Looking at the global OTC market, another participant warned that the fragmentation of Post-Trade liquidity among national infrastructure providers was a problem that would increase the cost of hedging. The result would be more volatility – with an adverse impact on food prices, for example.

There was also a problem of politicians changing their minds about regulation. This was a particular problem with trade repositories where he detected a collective regulatory failure brought about by the dogged and determined pursuit of individual regulatory mandates. This was more a problem for Asia than Europe, although in Europe political leaders had not been determined enough to prevent individual member states from pursuing their own trade repository solutions.

Yet another speaker highlighted the difficulty of getting the balance of regulatory outcomes right. In the case of CCPs, the ideal would be to have more than one but less than five. But
no-one knew how to achieve this. As an aside, this participant suggested that the ECB would perhaps have been better advised to spend its time and resources on developing a solution to integrate clearing and CCPs rather than devising and investing in its T2S securities settlement project.

vi) In response, there was an appeal to the industry representatives to tell financial attachés what aspects of the regulations needed to be fixed along the lines of: don’t just complain; please explain.

On the other hand, there was also a reminder that the Commission was against too many exemptions because they could produce loopholes that undermined its goal of reducing risk.

A matter of widespread concern was the sheer volume and complexity of legislation in prospect. It was difficult to reach clear, common, definitions and understandable texts. The securities law directive, for example, had stalled because it had been approached too much from a lawyer’s angle without explaining the expected benefits, such as legal certainty, financial protection, and increased economic growth. There were several complaints about legislation bunching in the Commission and other institutions such as the council, at well as the perceived failure to link up better the processing of legislation through the EU institutions.

The fact that some people were already mooting an Emir II or an EMIR III was a sobering reminder of the capacity of Brussels to generate legislation. As the meeting drew to a close, one official suggested that a job for the next Commission would be to see how compatible all this legislation was. This could not be a project for the short term, because of the huge amount of work in progress.