EU market regulation: A rude wake-up call?

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New rules in the European Union are forcing European banks in India to reconsider their clearing operations based out of India. In response to the financial crisis, the EU adopted the European Market Infrastructure Regulation (EMIR) in August 2012 to increase transparency in the "over-the-counter" (OTC) derivatives market and to mitigate systemic risk by reducing operational as well as counterparty credit risk. Once fully implemented, the EMIR will require certain classes of derivatives to be centrally cleared.

The EMIR also prescribes risk-mitigation techniques to be applied for uncleared OTC derivatives and aims to create reporting obligations for all derivative contracts.

International applicability

To ensure that European banks do not skirt around the EMIR through their foreign branches, the EU has sought to ensure that EMIR-related commitments applicable to EU members are implemented in a similar manner by the EU's international partners. Article 25 of the EMIR requires central clearing parties (CCPs) in other global jurisdictions providing services to EU-registered banks to be approved by the European Securities and Markets Authority (ESMA). This approval depends on whether the ESMA determines the legal framework of a global jurisdiction to be the equivalent of the EU framework. For instance, the ESMA recognizes the clearing framework established under the Dodd-Frank Wall Street Reform and Consumer Protection Act of the US as an equivalent framework.

Once the EMIR comes into force, European banks and their foreign branches will be barred from dealing with any non-recognized CCPs in other global jurisdictions.

On 1 October this year, the ESMA is due to provide technical advice to the EU on the equivalence of legal frameworks of various jurisdictions (including India). Prior to the determination of such equivalence, non-EU CCPs are required to file an application with the ESMA to be treated as a "qualifying CCP" (QCCP), i.e. a CCP whose jurisdictional legal framework is being examined by the ESMA for "equivalence".

Filing this application will allow such QCCPs to function for a period not exceeding 180 working days from the date of application, until their jurisdictional legal framework has been assessed by the ESMA.

Third-country provisions

Article 25 of the EMIR has raised some eyebrows in India, with Indian regulators perceiving the EMIR to be a case of territorial overreach. The Reserve Bank of India has not expressed any intention of applying for equivalence to the ESMA, as it appears to believe that this may result in ceding regulatory ground to an authority that is essentially exercising extra-territorial jurisdiction over the activities of Indian CCPs.

Consequently, the Clearing Corporation of India Limited (CCIL), which was expected to have applied for recognition under the EMIR, has not yet filed such an application. Therefore, from 1 October, if the ESMA decides that India's regime is not "equivalent", the CCIL will not be considered as a QCCP, thereby depriving European banks of breathing space to plan their India strategy. Starting 1 October, the EMIR could force European banks to abandon any business activities that require clearing in India.

A potential work-around for European banks could be to convert their branches in India into subsidiaries since the EMIR does not apply when EU banking groups access non-EU CCPs through local subsidiaries. In contrast to local branches, local subsidiaries are not considered as EU clearing members (which have to comply with the EMIR). However, the regulatory hoops which European banks will have to jump through, and the associated costs, to turn branches into subsidiaries make this an unviable alternative.

Moreover, recently issued EU capital requirement regulations, which apply to both bank branches and subsidiaries, have led to confusion on whether local subsidiaries of European banks have to provision at a higher rate for exposure to non-EU CCPs/non-QCCPs. Notably, while CCPs from some jurisdictions have rushed to submit applications to the ESMA, the Canadian Derivatives Clearing Corporation believes that it does not need to go through the "equivalence" process as only subsidiaries of European banks are present on its list of clearing members.

Conclusions

The decision not to submit an application to the ESMA already appears to be assuming diplomatic overtones. Unless India and the EU work out a mutually beneficially "middle-path", European banks may eventually be forced to exit from the Indian OTC derivatives market. Given that India does not rank as a significant jurisdiction for the EU in terms of exposure related to cleared trades and outstanding liabilities, the chances for a compromise to be worked out between the EU and India may be bleak.

European banks with Indian operations are awaiting the effects of the 1 October rules with bated breath.

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