The EU's post-Brexit policy on euro clearing explained

The UK's withdrawal from the EU has reignited concern about the long-standing 'tug of war' over the clearing of euro-denominated instruments – first and foremost, derivatives. ***Scott James*** *(**KCL**) and* ***Lucia Quaglia (University of Bologna)*** *explain the EU's post-Brexit policy on euro clearing.*

Clearing is the process by which a 'clearing house', also called a 'central counter party' (CCP), acts as the middleman for both the buyer and the seller of a financial instrument. Clearing is crucial for financial stability and the effectiveness of monetary policy. It is also a lucrative financial activity, especially for derivatives, and it is an important source of tax revenue and employment for those financial jurisdictions in which a large volume of trades are cleared. Since the bulk of clearing in Europe as well as internationally takes place in the UK, the tug of war for euro clearing has implications for the regulation and functioning of derivatives markets worldwide.

At the height of the sovereign debt crisis in the euro area in July 2011, the European Central Bank (ECB) issued a policy paper calling for CCPs that cleared a significant proportion of euro-denominated financial instruments to be located in the euro area. The proposal was strongly opposed by UK policy-makers, keen to retain the profitable euro clearing business in the City of London. Although the UK successfully challenged the ECB's plans before the European Court of Justice (ECJ), efforts to revive the so-called 'location policy' for euro clearing gathered pace following the Brexit vote. The tug of war for euro clearing concerned two inter-related aspects: the location of third-country CCPs clearing transactions in euros (or, to be precise, the 'recognition' of such CCPs, whereby financial operators in the EU would not be allowed to use 'non-recognised' CCPs) and the supervision of CCPs, within and without the EU. These issues were sources of significant contestation not only between the EU/euro area and the UK, but also between the EU and the United States (US), as well as within the EU/euro area itself.

At the beginning of the Brexit negotiations, it was widely expected that euro clearing would eventually be moved out of London. Yet, the legislation provisionally agreed by the EU in April 2019 (the so-called EMIR 2.0) rowed back significantly from the ECB's original location policy, as it envisaged that third country 'systemically important' CCPs would be subject to stricter regulatory requirements and strengthened EU-level supervision. If the requirements were insufficient to mitigate the potential risks, 'substantially systemically important' CCPs would be derecognised and would be authorised to provide services to EU customers only if the CCPs were (re)located in the EU. Importantly, however, additional safeguards where inserted, so as to make the derecognition of CCPs in third countries (first and foremost, in the UK) as the very last resort.

The EU's resistance to introducing a strict location policy for euro clearing is puzzling in several respects. Euro clearing has significant implications for financial stability across the EU, and the effectiveness of monetary policy within the euro area. It is also an important source of tax revenue and employment for those financial jurisdictions in which a large volume of trades are cleared. We would, therefore, expect the main EU authorities (the Commission, the ECB, and the European Securities and Markets Authority [ESMA]) to push strongly for the relocation of euro clearing to the EU after Brexit. Member states with large financial centres (notably, France, Germany and Italy), together with their established CCPs, also stood to gain considerably from greater third country restrictions. How can we explain this?

We argue that conventional political economy explanations provide only a partial answer. For example, national economic interests do a good job of explaining the concerted push by French and German policy-makers, and their respective financial centres, to adopt euro clearing restrictions. They also account for why the UK and the US policy-makers, allied with their national financial industries, sought to resist euro clearing restrictions. In practice, however, US and UK regulators had divergent preferences on crucial aspects of CCP regulation, and their efforts to lobby against the changes were viewed as ineffectual. Opposition from US and UK regulators therefore provides an unsatisfactory account of why the EU chose to resist Franco-German pressure to relocate euro clearing.

What about the role of the financial industry? Quiet opposition certainly did come from a small number of French and German 'dealer' banks, responsible for the bulk of trading in derivatives, which lobbied the Commission and Parliament against the increased costs of market fragmentation. Problematically, however, EU-based CCPs (notably, those in France, Germany and Italy) strongly favoured relocation as they were well placed to attract business away from London, while financial and non-financial end-users of derivatives were weakly organised. There is therefore little evidence of a powerful, unified transnational coalition of financial interests mobilised against new euro clearing restrictions.

To get a fuller picture of the EU's post-Brexit policy on euro clearing, an understanding of the complex inter-institutional politics of EU financial regulation is essential. We argue that the EU's cautious approach was shaped in large part by bureaucratic competition – or tug of war – between the Commission, the ECB and ESMA, as well as national regulators, over the location and supervision of CCPs. In particular, the outcome of EMIR II reflected the need to reconcile divergent bureaucratic interests and policy preferences. Hence, the Commission had long been sceptical of relocation on the grounds that this would threaten the integrity of the single market, and would impose significant economic costs on EU27 banks. Instead, it preferred to strengthen the EU's third country equivalence regime to give the Commission powers equivalent to US regulators. By contrast, the ECB strongly supported relocation to the euro area on financial stability grounds, and demanded greater powers of oversight for itself over clearing. Meanwhile, ESMA made a concerted push to increase its own powers by advocating the centralised supervision of EU and non-EU CCPs. Crucially, these inter-institutional battles are also embedded in fundamental questions about the future of euro area integration, and the relationship between EU27 and euro area institutions. Ultimately, it was the need to balance these competing bureaucratic interests that explains why the EU resisted pressure to introduce a strict location policy in response to Brexit.

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