Brexit threatens the City's future in European payment systems

Future UK-EU relations are about to be negotiated in Brussels. While there are signs of improvement in many important policy areas such as citizens' rights, the financial settlement, and the impact of Brexit on the island of Ireland, little progress has been made on the role of the City as the location of Europe's major clearing house, which is represented by the London Clearing House (LCH) and owned by the London Stock Exchange, write ***Corrado Macchiarelli (Brunel/LSE)*** *and* ***Mara Monti (LSE).***

London has an unparalleled position in terms of over-the-counter (OTC) foreign exchange and interest rate derivatives trading, particularly in the euro market and, to a great extent, the US dollar market.[1] The UK is the market leader in interest-rate derivatives denominated in euro (75 per cent) and pound sterling (95 percent), while the US remains the market leader in US dollar denominated interest-rate derivatives (78 per cent). Both the UK and the US have increased their positions: almost half of the UK's trade in OTC interest-rate derivatives is denominated in euros (48.6 percent) compared to transactions in pound sterling (4.7 per cent) and US dollars (5.4 per cent).

A majority of the clearing and risk management for euro-denominated interest rate swaps is currently conducted in London: about 50% of all interest rate swaps settled via Central Counterparty Clearing Houses (CCPs) and even 95% of the respective Euro-denominated interest rate swaps are settled at the LCH, against 13% cleared in Paris and 2% in Frankfurt (Bank for International Settlements' data in 2016). Europe's major clearing house is thus LCH, with 650 billion in euro derivatives traded daily in 2018, followed by Eurex Clearing owned by Deutsche Boerse.

This explains why the location of systemic clearing facilities has now become by far the most contentious issue in Brexit finance discussions, as we have highlighted in a recent note to the European Parliament. Just one day after the no-vote in the UK referendum, French President François Hollande stated that euro clearing facilities could no longer be based in London if the UK left the EU. The issue has been quarrelsome since 2011, when the UK challenged the ECB before the European Court of Justice (ECJ) on its rules mandating CCP facilities clearing in euro to be based in the Eurozone. The ECJ annulled the ECB's European Oversight Policy Framework on 4 March 2015, ruling that the ECB lacked the necessary competence to regulate the activity of securities clearing systems, being its competence limited to payment systems. The European Commission has recently suggested challenging this position should the EU and the UK authorities fail to come to an agreement on "enhanced supervision" of CCPs based in London.

It is not illusory to believe that euro derivatives clearing can be mandated to move, despite the fact that it would not be an easy move. The large OTC derivatives business depends on an ecosystem of players that cluster in large financial centres and the existence of economies of scope and of scale will certainly favour the emergence of very large service providers, particularly in the light of the European Capital Market Union (CMU).

However, there is no euro-area equivalent of a large centralized clearing services provider like LCH Clearnet. At present, the largest CCPs in the euro area are Eurex Clearing in Germany, the LCH Clearnet Group owned LCH SA in France, EuroCCP in the Netherlands and CCG in Italy. These large euro-area CCPs are nevertheless limited in their coverage. Hence, an excessively protectionist reaction will risk damaging the EU, and favour the US, with a lot of the businesses having incentives to move overseas.

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One of the main issues once the UK will withdraw from the EU is that the European law would require the EU to determine that the UK has an "equivalent" regulatory regime for its trading and clearing platforms. This is the same "equivalence" process that applies to other non-EU members such as the United States. All third countries' CCPs applying for the right to operate in the EU must be authorized by the European Securities and Markets Authority (ESMA), the European financial watchdog. Leaving the EEA, in particular, would mean that the UK would no longer be legally liable to comply with the EMIR (European Markets Infrastructure Regulation or Regulation) framework. While it seems highly unlikely that European authorities would allow such a high volume of euro-denominated transactions to be conducted in a country outside of its regulatory jurisdiction, failure for the UK to comply with the equivalence status would mean European financial firms will face higher capital charges for transactions cleared and settled in the UK, as it would limit the efficiencies that investors could otherwise obtain by managing euro-denominated transactions with the rest of their portfolios. This could reduce network effects and raise the costs for businesses transacting in euro-derivatives, consequently affecting their location decisions.

Negotiators will thus be confronted with the greatest challenge of agreeing to a process which does not add to the existing uncertainty regarding the post-Brexit scenario. Appropriate transition arrangements will be essential. The risk is that the fragmented and comparably small size of the market landscape in mainland Europe seems to suggest that especially those UK-based clearing houses with no subsidiaries in Europe may choose to migrate overseas and, in particular, in countries which have been granted already equivalence status – such as the US – because these markets are big enough to allow the creation of the necessary margin pool benefits through portfolio efficiencies and economies of scale/scope.

If the EU insists that clearing of euro-denominated products cannot occur in London that could also rise to questions as to whether euro-clearing can occur anywhere outside of the EU, including in the United States. This could lead to other countries considering whether to adopt similar policies regarding clearing of products in their own currencies. Today, the volume of euro-denominated products cleared in the US is quite small but the volume of dollar-denominated derivatives clearing that takes place in London is large. The US has never insisted for the dollar-denominated products to be cleared in the US, – differently from the EU, the US only requires overseas clearinghouses doing substantial US business to register there and provide access just like any other US-based clearinghouse. This framework gives the US the ability to jointly oversee its foreign clearinghouses, without necessarily applying any location policy.

We believe that going forward a joint approach, as is applied currently to EU-based CCPs that operate in the US, could be viable, with the EU and the UK sharing supervisory roles for systematically important extraterritorial CCPs. This approach may be the one involving lower costs, particularly when it comes to minimizing any dangerous gaps between the UK exit and its "equivalence" status recognition.

This post represents the views of the authors and not those of the Brexit blog, nor the LSE.

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[1] OTC interest-rate derivatives represent more than two-thirds of the overall OTC derivatives market globally.