

The fight over clearing euro derivatives

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In its proposed model to supervise the clearing of euro derivatives following Brexit, the Commission fails to appreciate the huge volume of business that will be disrupted.

The fight over City business has reached dramatic proportions in a very arcane domain, derivatives clearing. The European Commission has proposed to bring all third-country business conducted in euro under the direct supervision of the European Securities and Markets Authority (ESMA), which has infuriated the UK and the US. With Brexit looming, a huge problem is the possible non-recognition of the UK's clearing infrastructures, and the related derivatives contracts, which would require costly duplication of effort and a massive migration to EU-27 entities.

The City is the preeminent place for the clearing of derivatives trades, even more so following the G-20 commitment to centrally clear OTC contracts. In the interest rate swap market in the EU, for example, one London-based entity house clears about nine out of ten of all centrally-cleared OTC trades, mostly in euro, which is about 85% of all outstanding OTC contracts in the EU (according to data from the International Swaps and Derivatives Association). Three-quarters (of total outstanding notional) of these trades take place in contracts between a group of 16 dealers and/or other banks, all of which are based in the City.¹

¹ See European Systemic Risk Board, "Shedding light on dark markets: First insights from the new EU-wide OTC derivatives dataset", ESRB Occasional Paper, Frankfurt am Main, May 2016.

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Thinking ahead
for Europe

The financial stability implications of clearing have since long been an issue of concern. With Brexit looming, the European Commission has recently proposed to bring all third-country business conducted in euro under the supervision ESMA, with the exception of the clearing houses within the EU. ESMA would recognise third-country clearing houses that do business in the EU, with the possibility to conduct impromptu on-site visits and impose fines, and eventually, to mandate re-location to the eurozone. The European Central Bank has also proposed to change its statutes, which in reality entails an EU Treaty change, giving it a supervising authority over clearing houses.

The problem is that the EU-27 has got it wrong on the supervisory model and does not seem to appreciate the volume of disruption to business that will surely take place in derivatives clearing as a result of Brexit. Only third-country clearing houses will be supervised by ESMA in the EU, while local central counterparties (CCPs) would continue to be licensed by national authorities. This means that the business that migrates from London would be less centrally supervised than it was before, leading to possibly uncoordinated supervision, involving several national and European bodies, for only a few but systemically very important clearing houses. In addition, ESMA and other bodies still need to build up their supervisory expertise in this domain.

Furthermore, the uncertainty of what will happen with derivatives contracts with UK-based entities after Brexit could be hugely disruptive. In the likely event that the EU and the UK refuse to recognise each other's regulatory system – as part of the equivalence procedure – membership and contracts will have to be duplicated with entities based in the EU-27, which will increase costs and reduce netting efficiency. This will also create a fragmented and less-efficient on-shore market in the EU. It seems very dangerous to make this business a hostage to the broader Brexit discussions. Continuity is key, for many banks and institutional investors on the continent as well.

The EU's proposals have also raised concerns on the part of other trading partners, most importantly the US, as they could allow ESMA and the ECB to exercise authority over US-licensed entities. This possibility has even caused consternation in the White House, it is said. In addition, it is unclear whether the current system of equivalence between EU and US oversight of such infrastructures will still be valid after Brexit. The US authorities could decide that the current agreement is no longer valid, leading to another possible source of disruption.

CCPs have become more central to the global financial system since the crisis and therefore require close supervision. The Commission's proposal, however, does not create a sufficiently integrated structure within the EU; on the contrary, it looks rather like a half-way house that is trying to keep too many entities under its roof – the ECB, ESMA and the national authorities. Given the dominant role played by the City in this business and the legitimate needs of financial services users on the continent, certainty needs to be given soon to the markets about business continuity after Brexit.