

# BREXIT AND OTC DERIVATIVES CLEARING: THE ROLE OF POLITICS

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This presentation is based on the following:

Guido Ferrarini and Davide Trasciatti, Brexit and OTC Derivatives Clearing: The Role of Politics, *EBI Working Paper* (forthcoming)

Guido Ferrarini and Davide Trasciatti, OTC Derivatives Clearing, Brexit and the CMU, in D. Busch, E. Avgouleas and G. Ferrarini (eds), *Capital Markets Union in Europe*, Oxford University Press (forthcoming)

# 1. Paper's aim and scope

- a. Significant impact of Brexit on OTC derivatives clearing which is presently mainly performed in London also for derivatives in euro
- b. *Main thesis*
  - i. The efficiency of clearing is generally optimized through concentration in a small number of clearing houses
  - ii. A disruption of the City's clearing industry post-Brexit would not be in the interest of Europe
  - iii. The relocation of part of the OTC derivatives industry to the EU post-Brexit could be efficient under given conditions

c. *Implications and proposal*

- i. The decision as to either keeping the *status quo ante* or fragmenting the clearing markets should be taken by market participants mainly focussing on the direct and indirect costs of clearing to them
- ii. Similarly, UK CCPs and their corporate groups should be free to decide either to keep their clearing activities in London or move the same to their EU subsidiaries under equivalent conditions
- iii. EMIR reform is needed in order to support both the maintenance of the *status quo* after Brexit and the relocation of clearing activities to the EU financial centres

## 2. *Status quo v. Relocation*

### a. *Economics of clearing*

- i. The economies of scale and scope of clearing favour the incumbent providers with respect to new entrants
- ii. The consolidation of clearing in a few CCPs lowers transaction costs significantly, whereas fragmentation across multiple CCPs may deliver a suboptimal outcome in terms of market efficiency
- iii. The concentration dynamics and the increasing globalization of the clearing industry carry financial stability implications

*b. Market for clearing*

- i. In Europe, the market for OTC derivatives clearing is concentrated in a UK based CCP, which services more than the 95% of the European OTC market
- ii. The City of London is host to a variety of ancillary services (like a solid market for Repo transactions) that benefit the overall dynamics of OTC derivatives clearing
- iii. Fragmenting the OTC derivatives industry post-Brexit would likely increase transaction costs, while financial stability benefits would appear dubious

c. *Location policy*

- i. The ECJ decided the ‘location policy’ case brought by the UK against the ECB in favour of the plaintiff (2015)
- ii. EMIR’s single rulebook and a strong culture of supervisory cooperation have proven to be a reasonable framework for addressing the financial stability concerns raised by the location of most CCPs in the UK
- iii. The ECB and the Bank of England have consolidated their cooperation in the oversight of CCPs through a bilateral swap line, which enables them to mutually support the liquidity needs of relevant CCPs at any time
- iv. The main lesson taught from the experience so far is that whether a CCP is located in the Eurozone or in the EU is not too relevant from a financial stability perspective, once effective supervisory arrangements are in place

*d. Relocation of UK clearing*

- i. Relocating clearing activities to the EU would be costly both for individual institutions and for society, and would raise unprecedented legal challenges
- ii. The relocation of OTC clearing might be suboptimal in the long-run from a market efficiency perspective, while setting the conditions for new systemic concerns
- iii. UK CCPs could either set-up subsidiaries in the EU or expand the activities of existing ones
- iv. The outcomes of similar strategies are not easy to predict
  1. it is not sure whether one or more EU-based CCPs will be able to offer comparable prices and conditions of service, in terms of margining and funding
  2. scale economies make clearing subsidiaries more costly to run than banking subsidiaries given the fragmentation of the clearing pool within the relevant group

e. *Repo market v. Clearing market*

- i. Other cleared markets, such as the Repo market, which is an important funding source for banks active in the derivatives market, could relocate to the continent in advance of Brexit even in the absence of regulatory interference. However
  1. repo transactions are different to OTC derivatives, for they normally are short-term and their clearing is relatively fragmented amongst Member States
  2. infrastructural efficiencies in the settlement of repos related to the T2S system deliver cheaper settlement conditions in the EU than in the UK
  3. while the derivatives market is of systemic relevance due to its concentration and sheer size, the repo market is systemic per se, as central banks use it for purposes of monetary policy

- ii. The relocation of the clearing industry could be suboptimal in terms of market efficiency, as the clearing landscape could fragment across reference currency zones leading to the formation of an EU-captive pool of liquidity, with a negative impact on clearing costs
  - 1. it is not sure that the clearing of non-euro derivatives will also move to the Eurozone, given the lack of liquidity and scale of the clearing of such products in the EU
  - 2. market participants might incur higher costs and lose the benefits deriving from keeping their portfolio concentrated in a single CCP
- iii. However, the creation of an EU-captive pool will not break the interdependencies between the EU and the UK financial systems, which would nonetheless remain highly interconnected

### 3. Role of Politics

In this section, we investigate why and how national interests and/or interest groups might work against the maintenance of the *status quo* and for the relocation of clearing activities to the Eurozone

#### *a. Equivalence*

- i. Under Article 25 EMIR, a CCP established in a third country may provide clearing services to either clearing members or trading venues established in the Union provided that the Commission has adopted an “equivalence decision” and ESMA has recognized the CCP at issue
- ii. The relevant process is relatively cumbersome and unpredictable, and therefore less attractive for the UK CCPs than the single licence presently in force

1. the equivalence regime leaves room for discretion and political interference also considering the high stakes involved
2. technically it should only be invoked after the UK has become a third country, which would create a regulatory cliff-edge at the time of Brexit
3. for the UK CCPs to be recognized in advance of Brexit under a model of pre-emptive equivalence, the political consensus of the EU and its member States would be required
4. concerns arise from a systemic perspective, as EMIR does not foresee the ECB's active participation in the equivalence decision and in the recognition procedure, but only a consultative role
5. the equivalence framework is intrinsically unstable, for the Commission is entitled to revoke its equivalence decision at any time, for instance after changes to either the third-country's laws or the EU regulatory framework

*b. Trade agreement*

- i. Such an agreement would entitle UK CCPs to access the EU single market under conditions similar to those presently enjoyed by them under the single passport
- ii. Several conditions should be agreed upon as to the cross-border provision of financial services
  - 1. substantial divergence between the respective rulebooks should be avoided in the future, so as to allow the continuing mutual recognition of supervisory systems
  - 2. appropriate enforcement and dispute resolution mechanisms should be provided for
  - 3. the agreement should also cover the central banks' liquidity assistance to CCPs

- iii. Successful negotiations of a trade agreement depend on the political will of the parties involved, which would surely be influenced by a broad set of interests and values, such as those concerning the Treaty's fundamental freedoms
  - 1. Some member States (France and Germany in particular) would likely protect their own financial centres and clearing industry, objecting to the recognition of UK CCPs' access rights to the single market and/or requesting conditions unacceptable to the UK
  - 2. The high number of veto-empowered institutions involved in the negotiation procedures - such as the Council of the European Union, the European Parliament, the UK Parliament, the Member States' Parliaments and in some cases regional Parliaments - could hinder an efficient outcome of the negotiations within the time allowed under Art. 50, even assuming an extension of the same.

- iv. On the whole, the future of the OTC clearing industry is commingled with the fate of Brexit negotiations, which presently remains difficult to predict
  - 1. The EU institutions and Member States are substantially aligned
  - 2. The EU Parliament and the Council share a common position: They will not let the UK cherry-pick amongst the Treaty's fundamental freedoms, also to discourage similar attempts by other EU countries
  - 3. This common position surely mirrors that of some Member States (France and Germany in particular), which have vested interests in the relocation of OTC derivatives clearing to the Eurozone
  - 4. The ECB will have a key role to play as to the relocation of euro-derivatives clearing to the Eurozone, as already shown by the same when adopting the location policy which was found ungrounded by the ECJ

c. *EMIR reform*

- i. A reform of EMIR enhancing the surveillance over third-country clearing providers under the equivalence and recognition regime already in force is another option available, which would ease maintaining the *status quo* without excluding the stipulation of a free trade agreement
- ii. The Commission has recently published a proposal to this effect
  - 1. EMIR's supervisory framework relating to third-countries' CCPs would be amended through Brexit-driven provisions
  - 2. the supervision of EU-based CCPs would become semi-centralised through the institution of a new supervisory body identified as the CCP Executive Session within ESMA's Board of Supervisors

## 4. A critical appraisal of the Commission's proposal

- i. The proposal of the Commission introduces a new binary classification of third-country CCPs, distinguishing between those that do not pose a material risk to the EU financial stability (Tier one) and those that presently are or are likely to become systemically relevant (Tier two)
  - 1. Tier-two CCPs would undergo an enhanced regulatory framework consisting of a sliding scale of (additional) prudential requirements

2. They would be authorized by ESMA and be subject to the regulatory and supervisory powers of EU authorities, including the right of central banks of issue to impose additional requirements
3. Where these additional requirements did not sufficiently assure the EU financial stability, ESMA could recommend the Commission to adopt an individual location decision, declaring that the scrutinized CCP may provide clearing services only by relocating its activities inside the EU

- ii. The proposed reform is open to criticism on various counts
  - 1. Third-country CCPs would be subject to double compliance and therefore experience additional costs with respect to EU CCPs
    - a. The proposal foresees a waiver allowing for substitute compliance, which would limit the costs at issue [add on art 25 c], but much is delegated to level 2 measures
    - b. Moreover, the substitute compliance mechanism is subject to the risk of conflicting rules in different jurisdictions

2. ESMA's power to adopt a location decision is disruptive and could determine unintended consequences
  - a. UK CCPs will confront an (implicit) threshold for third-country clearing providers, which may incentivize them not to expand their volumes, despite the fact that the clearing's economy naturally strives for scale and size
  - b. Relocation measures by ESMA are not very different to imposing these measures ex ante by regulatory fiat
  - c. The proposal does not clarify the practical scope of the location decision, i.e. its granularity level: a location decision may be at CCP, clearing service or asset class level

- iii. One should ask how third countries other than the UK will react to the proposed EMIR amendments
  - 1. The enforcement of a strict location policy has in fact a few international precedents and deviates from the relevant international regulatory principles ensuing from the original G20 commitment
  - 2. The EC and the CFTC agreed to a common regulatory approach for transatlantic CCPs, based on deference
  - 3. A reform of the equivalence provision could lead the U.S. to countermeasures

- iv. The Commission's proposal would interact with the proposed amendment of article 22 of the ECB statute, which was recommended by the ECB on the first of July 2017
  - 1. This amendment would grant the ECB regulatory powers over clearing infrastructures, therefore covering the competence gap which was recognised in the location policy judgement
  - 2. An amendment to Article 22 represents a precondition for the ECB to exercise the powers which would be awarded to the same under the new equivalence and supervisory framework
  - 3. The EMIR review and the proposed new Article 22 would promote a supervisory role of the Central Banks of Issue in respect of CCPs consistently with the monetary policy tasks of the E(S)CB, given that the margin and collateral requirements established by CCPs may have a significant impact on monetary policy

## 5. Conclusions

- i. Main question dealt with in the paper: should OTC derivatives clearing for EU counterparties remain in London or relocate to the EU?
- ii. Paper's answer: market participants (clearing counterparties and CCPs) should take the relevant decisions based on the transaction costs of clearing, within an appropriate regulatory framework and without political interference

- iii. Nonetheless, politics will have a say in each of the options available for maintaining the *status quo* of the clearing industry in London: equivalence, trade agreement and EMIR reform
- iv. While the perspective of a trade agreement between the EU and the UK covering financial services is at the moment uncertain, a reform of EMIR is needed in order to strengthen the regulatory and supervisory framework of third-country CCPs in a way that is efficient post-Brexit
- v. However, the Commission's proposal should be amended and any location policy requirement should be avoided