Euro Clearing Should Stay In London

- **EU plans to seize regulatory powers over Euro clearing.**
- **This business is worth billions in revenue.**
- **It is a great source of employment.**
- **Moving it from London will prove highly inefficient.**

Negotiations over the UK's exit from the European Union (EU) are scheduled to commence this week, as scheduled, following the rather untidy UK General Election.

As this happens, European regulators appear determined to increase their regulatory grip on the clearing of derivative financial transactions denominated in Euro.

London is currently the leading centre in this market as it processes 75% of the transactions by financial value, supporting thousands of jobs. However, as the UK progresses toward an exit from the EU there is concern within the EU that the UK would continue its dominance when it will no longer be covered by EU rules and regulations.

This is a business that has been worth billions of pounds to the City of London, therefore is it any wonder that the bureaucrats seem determined to repatriate this business to a financial centre within the EU if they determine that handling such transactions outside the union would pose a risk to European financial stability.

What is Euro clearing?

It is not the most glamourous of activities in financial services as it operates behind the scenes of the noisy dealing rooms or cutting-edge computers that silently conduct programme trades.

It is the functional side of a financial utility that keeps the system operating where an intermediary act as the middleman or broker providing liquidity for both buyers and sellers of financial contracts tied to the underlying value of an asset such as a bond, currency, derivative, equity or index.

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Buyers and sellers deal with the "clearing house" (CH) rather than each other which centralises each step of the trade and makes the whole and sometimes complex business more efficient.

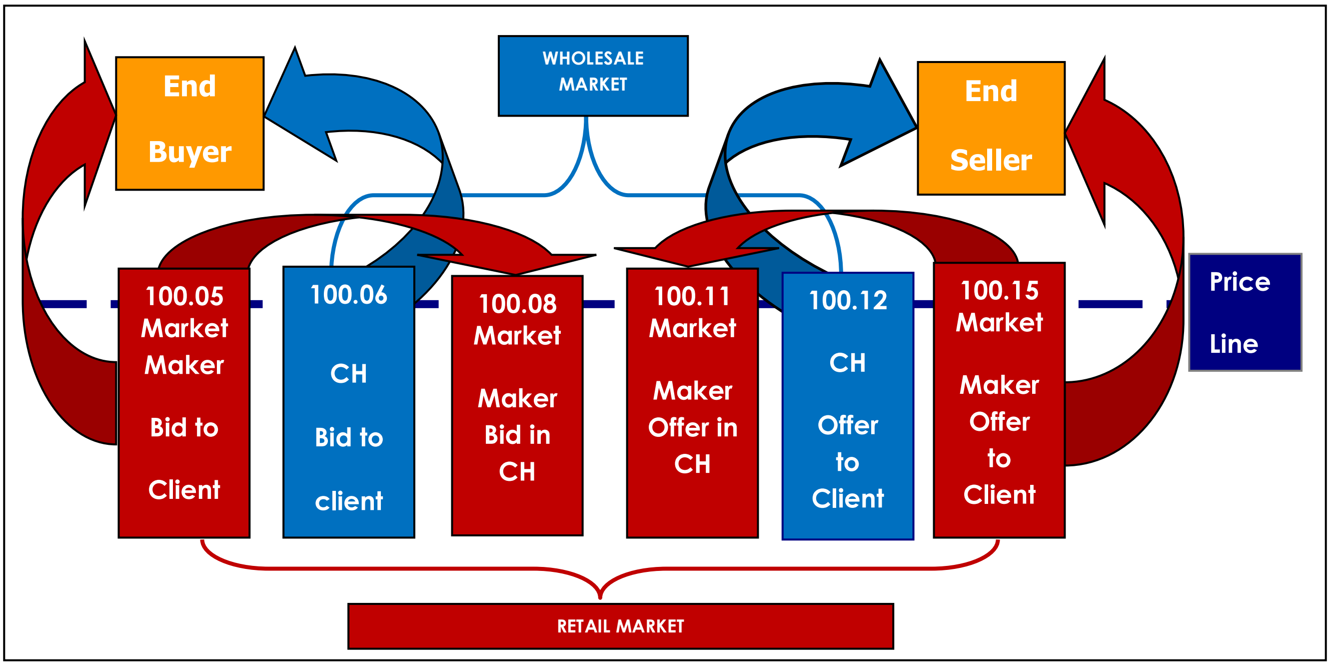

Figure 1: The Clearing House acts as a broker and can delivery sharper prices with client anonymity
Source: Spotlight Ideas

Figure 1 illustrates that the CH can provides the liquidity required by sellers and buyers, preserve their anonymity in the market and deliver sharper prices across a range of assets classes. However, the CH will bear the risks if one side of the transaction doesn't deliver the asset or pay the required cash on time.

The CH has one stipulation for its counterparties to such transactions. They are required to post money in an account with the CH in case there are settlement problems. This is not a wasteful use of working capital as one might initially conclude. The greater the amount of business done then the less money as a proportion of the trading volumes are needed to be kept in that account. This system seeks to reduce exposure of default risk and is cheaper, more efficient and effective for their customers.

London leads

London is the leading global force for clearing of all types of currency-denominated derivatives. The London Clearing House (LCH), which is part of the London Stock Exchange (LSE), clears EUR 927 Billion worth of Euro-denominated contracts on any given day, this is equal to 75% of the global market. To put this in context, the second ranked clearing centre is Paris with just 11% of the transaction volume.

Even the UK is on course to leave the EU and has never seriously considered joining the Euro London holds the edge given the pre-eminence and acceptance of English law and language and of course the City of London's reputation for efficiency.

This fact has not gone unnoticed by the EU and the two leading financial centres, Frankfurt and Paris are extremely keen to get their hands on some of the business and the employment that would be created. Not to mention the boost to government revenue from increased taxation receipts.

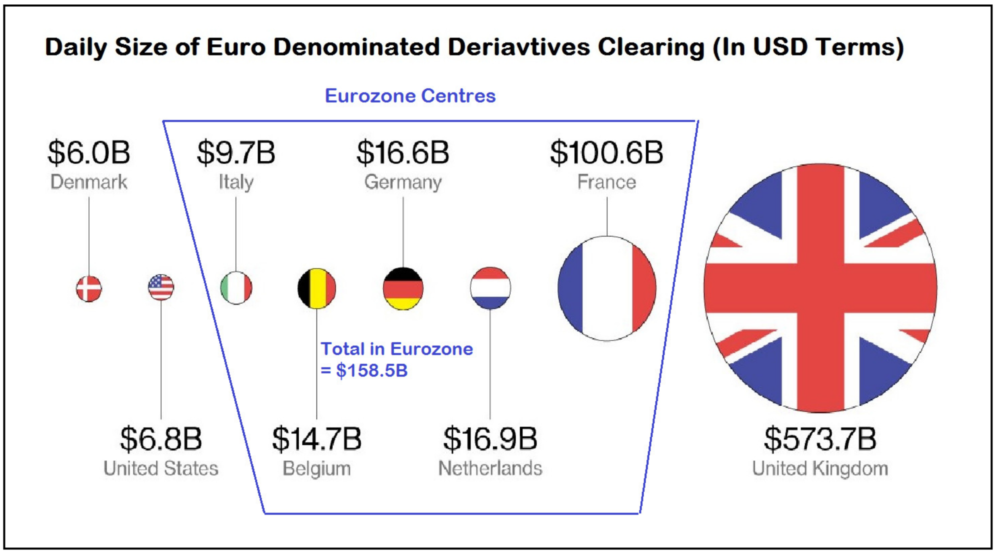

Figure 2: London Is Well Ahead In Terms of Euro Clearing
Source: Bank for International Settlements

It should be noted that six years ago the European Central Bank (ECB) demanded that all Euro denominated trades were done inside the Eurozone. This was a shining example of officials overstepping the mark as the European Court of Justice (ECJ) for once backed the UK who bought a case to the court when it declared that the ECB had no legal power to make such a demand. Of course, once the UK leaves the EU it will be extremely hard to make such a case again.

The UK, which brought the case, also argued that this would discriminate against non-eurozone countries who are part of the EU. Once the UK is outside the EU that defence would obviously no longer work.

A short-sighted position

The position within the City of London is that tearing away Euro denominated transactions from all other clearing activities would be inefficient as it would create a fragmented and less competitive market. The policy chairman at the City of London Corporation Catherine McGuinness said "fragmentation" of foreign exchange and interest rate trading could see firms' costs increasing by "as much as 20%".

Under such circumstances, firms looking to operate in a Eurozone based centre for clearing are most likely to fail to operate efficiently. This is a high risk as judging EU decision taking on its past track record there could be a split of business along asset class or counterparty lines between Paris and Frankfurt.

We can illustrate this with economic theory as the Inefficiency means that resources devoted to clearing outside of London are not being put to their best use. By deciding by bureaucratic diktat where Euro clearing business would be located it will create a case of dynamic inefficiency. This occurs when firms have no incentive to become technologically progressive as would be the case if a centre such as Paris were given all Euro clearing business on a permanent basis. This would be associated with a lack of competition and hence innovation...leading to higher production costs, an inferior service, and of course less choice for consumers.

This would ultimately lead to higher costs for European customers as enforcing a location policy for a given currency can cause the initial margin at a CH to be 25% higher than bilateral markets. Taking the business away from London would productively inefficient i.e. in London clearing is conducted by combining resources in such a way as to deliver the service at the lowest possible average total cost.

This can be illustrated by microeconomic theory as costs will be minimised at the lowest point on a firm's short run average total cost (ATC) curve where it equals marginal cost (MC), i.e. ATC = MC, because MC always cuts ATC at the lowest point on the ATC curve with the price charge being P_e.

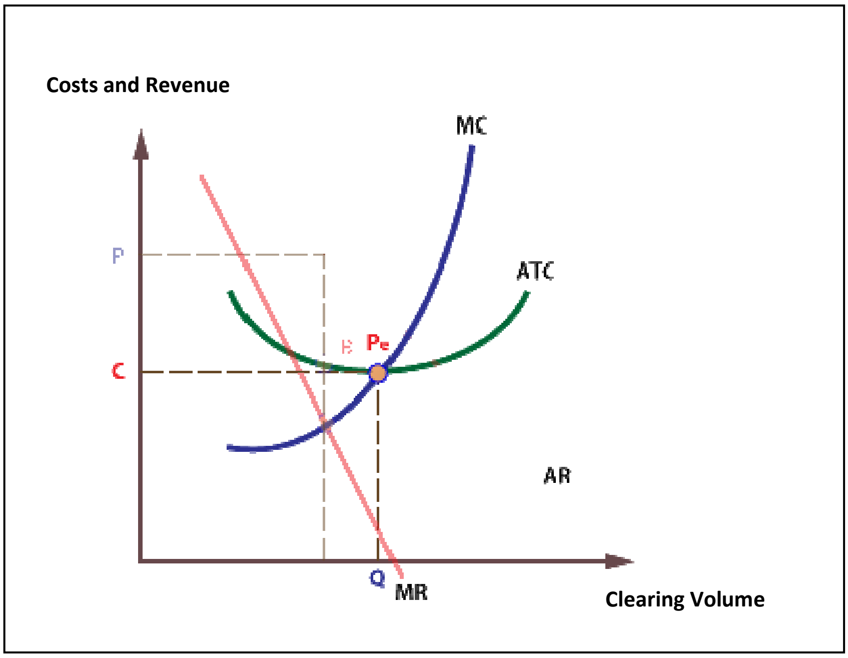

Figure 3: Dynamic Efficiency Seen In London Euro Clearing
Source: www.economicsonline , Spotlight Ideas

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The LSE has suggested that a smaller domestic pool of trading will cause increased costs and it will become more difficult for the members of the smaller pool to absorb any losses and as a result systemic risk would therefore increase. A figure has been put on such a move as the LSE Chief Executive Officer, Xavier Rolet said in total a move could cost investors EUR100 Billion over five years; i.e. the ATC in Figure 3 would move higher

The concept of moving Euro clearing to the is a complicated proposition as the bifurcation of cleared portfolios will make bilateral markets more attractive than cleared markets. In turn will raise questions over current clearing mandates.

A further critical problem is that such a proposal is in conflict with the G20 over the counter (OTC) market reforms intended to reduce systemic risk through the promotion of clearing.

Recall what was said about LCH dominant role? It should therefore be no surprise to learn that many members of LCH SwapClear © are based in the Eurozone and they have expressed no desire to see the Euro clearing business moved. Many are international operators and so Eurozone headquartered operators are not restricted to dealing only in Euro. Similarly, many US institutions trade Euro as well as many other currencies in addition to Dollars.

The EU should be aware that even if Euro clearing were stripped away from London it may relocate to ... the US as firms would seek to minimise the cost of disruption and fragmentation. After all, business in New York certainly has the scale to offer similar efficiencies to London. Paris and Frankfurt do not.

Job destruction

In an independent report conducted by EY for the LSE last year the conclusion was that as many as 83,000 clearing jobs could be lost by 2024. This would have a ripple effect and the LSE CEO, Xavier Rolet, said that 100,000 UK jobs would be at risk in the fields of risk management, compliance, middle office and back-office support functions.

In January Mr Rolet said that customers at the LSE are not going to wait and would move operations if the LSE did not have a clear path for continuing its global operation.

Speaking to MPs on the Treasury Select Committee, he said that there could be no doubt over the scale of the economic impact on jobs within the financial services sector.

"...I'm not just talking about the clearing jobs themselves ... But the very large array of ancillary functions, whether it's syndication, trading, treasury management, middle office, back office, risk management, software ..."

It is essential that David Davies, the Brexit Secretary and his team take a firm line and do allow the domination of London to be diminished to any degree. This is really being a case where the market has delivered a superior solution to anything civil servants and politicians could create.

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