Brexit and Clearing

Local, the new Global

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INTRODUCTION

As part of a regulatory response to the recent financial crisis, reform proposals were endorsed by the G-20 governments in 2009, making the central clearing of most OTC derivatives compulsory for most counterparties – with the view that the mandatory clearing mandate would improve the transparency and robustness of the financial system. These global regulatory changes have set the current status quo and had a number of implications, including a) a surge in demand for clearing services, b) concentrated liquidity at few global clearing houses, c) a handful of clearing brokers offering clearing services, and d) an increase in direct memberships from regional banks.

Major changes in fiscal and monetary policy following the financial crisis, as a secondary impact of the crisis, created a nationalistic political environment. This change in political sentiment has more recently started a second wave of reform with regional independence and national interest taking centre stage. This is now challenging the global status quo with significant implications in capital markets, specifically in the cleared infrastructure underpinning them.

For banks operating either as clearing brokers or clients, how the future plays out in central clearing will be crucial in anticipating the ways their businesses are impacted, considering the importance of a central clearing model in post-crisis regulation.

This paper analyses the implications for 3 different Brexit scenarios for central counterparties (CCPs, or clearing houses), clearing brokers and end users.

Area affected	Soft Brexit	Medium Brexit	Hard Brexit
Facing European clients	No change (passporting remains)	Capitalised entity required and local regulation applied	Capitalised and fully independent entity required
Clearing houses and liquidity	Additional regulation for global CCPs	European end users "encouraged" to clear all currencies with onshore CCPs	All euro-denominated clearing happens at onshore CCPs

Table 1 – The 3 potential types of Brexit and the different outcomes for the clearing space

Source – Sernova Financial

BACKGROUND AND BREXIT IMPLICATION

The financial markets have undergone a seismic shift in the last 10 years, as a result of a series of financial regulatory reforms.

Prior to the financial crash in 2007-2008, barriers to entry and regulatory burdens of operating in the financial markets were relatively light, allowing firms to easily expand into new countries. Companies demanded that the banks service them in all jurisdictions and the banking sector gladly obliged - it looked like globalisation was an unstoppable force that would march on unchallenged.

The 2008 financial crisis resulted in a global re-think in the way financial regulation is governed. The light-touch approach that the financial industry enjoyed in the past suddenly transformed into a heavily regulated space. For example, a wave of global regulation that emerged largely from the 2009 Pittsburgh G20 summit aimed to harmonise global financial incentives. The financial sector has implemented Dodd Frank, Basel III, and soon Mifid II in January 2018.

Also, the financial crisis significantly changed fiscal and monetary policy, which contributed to changes in global politics. This resulted in public sentiment turning against globalisation, meaning that both governments and global companies are now strongly encouraged to consider local interests and increase regional independence. The impact of the national focus is now being felt in financial regulation, as global policies are supplemented with heavy local requirements and onshore policies.

Signs of the localisation of regulation can be seen in Brexit, where banks that are looking to gain access to European clients will have to build an independently capitalised and managed entity in a member state of the European Union. In this case, there is global mandate to clear derivatives, but the requirement for that to happen onshore comes from a local regulator. The EU therefore is likely to face a more expensive approach to clearing that is similar to the structure that has already been implemented in the US, where banks wanting to perform client clearing (amongst other services) for their US clients needed to create a separately capitalised and managed entity. That has meant the provision of clearing services in the US not only became costly, but also came with a heavy regulatory burden imposed on the financial firms by FINRA, the SEC and the CFTC.

In addition, the regulators are more heavily considering the implications of systemically important financial markets infrastructure in order to ensure that the level of regulation and incentives of any crisis management are aligned to the members and currencies supported.

BREXIT AND THE CLEARING HOUSES

In May this year, the European Commission (EC) released a statement about growing concerns around CCPs occupying a more significant position in financial markets. Most importantly, the paper focused on the fact that cleared liquidity was starting to concentrate in a small number of CCPs, increasing systemic risk for the European Union.

Coupled with this, the implications of Brexit on the clearing world highlighted a number of perceived shortcomings in regulatory control concerning CCPs, such as potential conflicts and fragmentation in regulatory oversight.

One of the key concerns is that the current regulatory approach relies on internal supervision, where the local regulator does not have any direct interest in the implications of a disruption event to some of the currencies supported by the clearing house. Moreover, a CCP could be considered to be performing elements of a central bank's role with respect to monetary policy transmission since decisions by a clearing house around collateral eligibility and margin requirements affect the leverage in the banking sector.

For example, the Bank of England, the legal supervisor of UK clearing houses, would have a reduced interest in protecting foreign currency denominated trades over GBP transactions. On the flipside, other European central banks have no regulatory power to safeguard their own currencies that are cleared at a UK clearing house in the current regulatory structure. As such, a clearing house could exacerbate instability in a crisis scenario.

These concerns led the EC to propose changes to its current regulatory approach on two pillars. First, the EC proposed to centralise supervisory arrangements for European CCPs within ESMA. Second, third country CCPs would need to be classified as 'Tier 1 – Non-systemically important', or 'Tier 2 – systemically important'. This decision would be based on assessing the following criteria:

- Nature, size and complexity of the CCP;
- Effect of a failure/disruption;
- Membership structure; and
- Inter-dependency within the financial market.

Where a CCP is classified as Tier 2, ESMA would have supervisory control over key aspects, such as capital requirements, conduct, margining and the default fund. However, if the risks posed by the CCP were of significant magnitude, ESMA would be able to refuse authorisation as a third party CCP. As a result, in order to gain authorization, the CCP would be required to set up operations on EU soil.

The EC's proposal has similarities to the Japanese model, where the Financial Services Agency (FSA), Japan's financial watchdog, requires local banks to clear their yen interest rate swap business onshore. However, the Japanese approach to regulation is one step further than the proposal of the EC in some ways, given that the European proposal does not provide options for non-systemically important CCPs or greater regulation for off-shore CCPs. This means that local market participants can be protected by local regulators, but given the interdependencies between the global financial markets, it is questionable whether it gives sufficient control over the typical central bank functions for the currency as a whole.

The question remains as to whether, in a 'hard Brexit' scenario for example, we could witness the start of regulatory requirements for currencies (and securities in those currencies) to be cleared onshore, in order to allow central banks wider control over their own currencies' stability.

<u>What are the implications for CCPs in a 'medium' or 'hard Brexit'?</u>

At a minimum, it looks like the task of running a global CCP will get harder with additional regulators looking to have more say over how certain key risks are managed. Large CCPs like LCH.Clearnet (LCH) that are already overseen by both the Bank of England and the CFTC (with some lighter touch regulation in other regions) have some experience of this managing multiple regulators.

If ESMA did not authorise third country CCP clearing of euro-denominated trades, then significant euro liquidity would move to a Europe-based CCP. There are CCPs in Europe that clear euro, such as Eurex, Nasdaq and BME, but it is likely that the LCH would also look at finding a local solution that would suit ESMA. This would result in a proliferation of liquidity into local jurisdictions, reducing the netting benefits and widening CCP basis.

We question whether this could be a driving force behind a new type of inter-CCP clearing. Managing exposure across multiple clearing houses is a complex and costly task where, if some form of co-operation between CCPs could be established, it would result in significant benefits for market participants. How such a structure would be viewed by the regulators, given the regulators' desire to minimise interdependencies within global markets is very uncertain.

Clearing House Type	Brexit Type	Liquidity	Action	Implications for CCPs
Global CCP	Hard Brexit	All euro-denominated products move onshore	Create a new CCP onshore for only euro-denominated products	• ECB and ESMA become the sole supervisors of the new onshore CCPs • New default fund created • Local and global firms become members • Inter-CCP risk transfer is required
	Medium Brexit	All European users clear at onshore (EU-based) CCPs	Create new default fund for all clients based in the EU and for all products	• European Central Bank (ECB) and ESMA get significant supervisory responsibility over risk, collateral and governance policies for new default fund-based service • European clients'/members' collateral remain onshore • Need for dynamic CCP waterfall management
	Soft Brexit	No change	Accept greater regulation	• Potential for regulatory conflict
Local CCP	Hard Brexit	All euro-denominated products move onshore	• Concentrate on intra-currency cross-margin opportunities • Prepare for increase in volume and members	• Local CCPs need to look for margin offsets inside the local currency (e.g. Futures vs Rates vs Repo) • Infrastructure and policies might not be adequate for significant increase in volume and members
	Medium Brexit	All European users clear at onshore CCPs	Expand product scope to cover global currencies traded by European clients	• Local CCPs required to clear all currencies traded by European clients • Split pools of liquidity would demand inter-CCP risk transfer
	Soft Brexit	No change	No change	No change

Table 2 – Implications for clearing houses with regard to each Brexit type

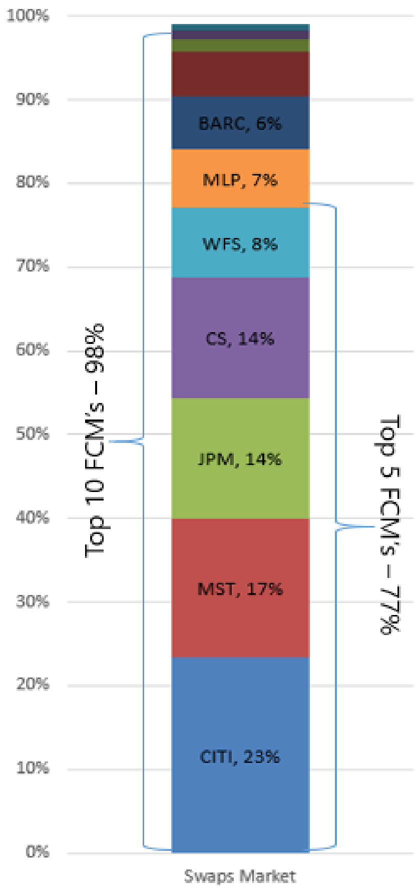
Source – Sernova Financial

One point is clear: the future structure of the cleared markets is far from certain and financial institutions need to maintain maximum flexibility in their approach to clearing over the coming months and years.

BREXIT AND THE CLEARING BROKER

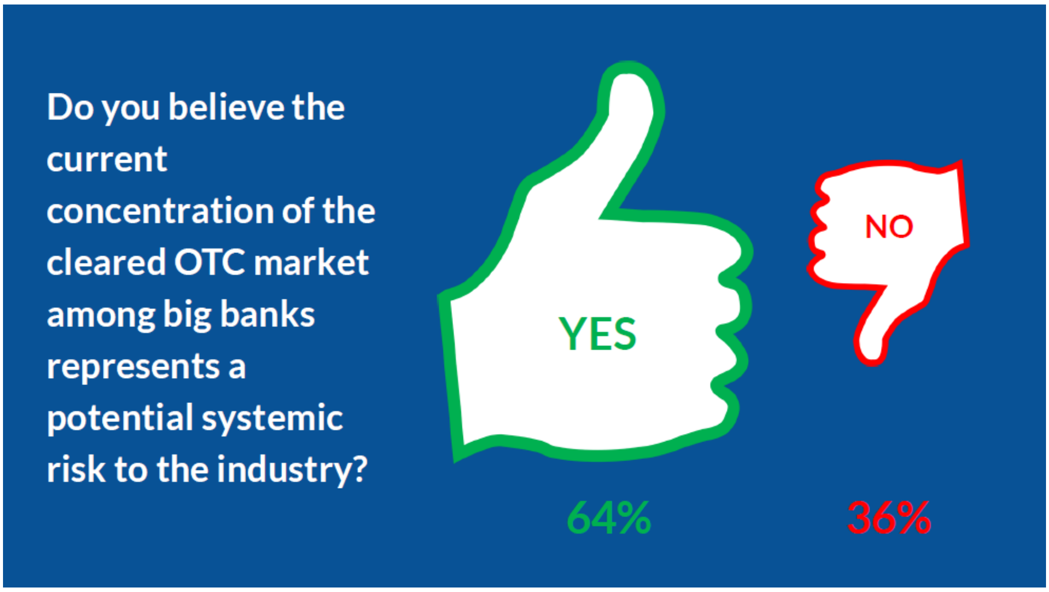
Even though change to the core location of liquidity is significant, more important in many ways are the changes affecting the clearing brokers, which have a much greater potential to disrupt the current market structure.

At present, the largest global banks dominate the cleared markets in Europe, just like in the US, where 75% of US client collateral in the OTC derivatives markets is placed with only 5 banks. This concentration has been caused by post-crisis regulation.



Graph 1 – FCM concentration by client assets

Source – The CFTC'S financial disclosure from August 2017



Graph 2 – Risk from clearing broker concentration

Source – DerivSource Webinar questionnaire – "CCP Clearing – How is the Market Evolving?"

In the US, the supplementary leverage ratio (SLR) has seen many of the largest clearing brokers – or futures commission merchants (FCMs) in the US – hike fees. The US ratio uses the internationally agreed definition of leverage exposure – that also includes received client margin – but applies a higher minimum compliance level of 5% for big banks, rather than 3%. FCMs also need to have their own treasury teams, management, onshore capital, regulatory and liquidity requirements.

Unable to combat the higher costs associated with the clearing business today, some FCMs have exited in recent years as meeting the return on equity threshold has been too much of a challenge. In the US, RBS, Nomura, Bank of New York Mellon and Deutsche Bank have all left, leading to a concentration among the largest clearing brokers.

We predict that the post-Brexit era will accentuate this trend, as global banks will need to operate with local capital, liquidity and staff. This may affect local entities' credit ratings, as banks must split their capital into multiple pools.

In the event of a 'hard Brexit', regulators may go one step further and require bankruptcy remote structures. This could mean that infrastructure would also need to be separate. Examples of this can be seen in recent ringfencing requirements in the UK, where banks have had to ensure that their investment bank entities are bankruptcy remote and they are separated from their retail entities.

"We will not accept empty shell companies. Any new entity must have adequate local risk management, sufficient local staff and operational independence" – Sabine Lautenschlager, vice chair of the Frankfurt-based Single Supervisory Mechanism

These changes present a significant opportunity for existing regional banks. As regulations break the global bank clearing monopoly, this allows regional banks to provide small-scale clearing services to their local clients and become more competitive. This is because regional banks, having a diversified business in a single entity and being subjected only to local regulators, will not suffer the burden of having to adhere to additional external regulations. In addition, regional banks are not subject to systemic capital uplifts, such as the G-SIB requirements, and with an increase in cloud-based clearing infrastructure solutions, these banks have the opportunity to enter into the client clearing business with minimum investment and a cost base that scales with revenue. Even regional banks that are not based in Europe can benefit from this trend, as global banks retreat from more local markets. Clients are demanding a local clearing solution and are looking to access to both local CCPs and global ones that regional banks are perfectly positioned to provide.

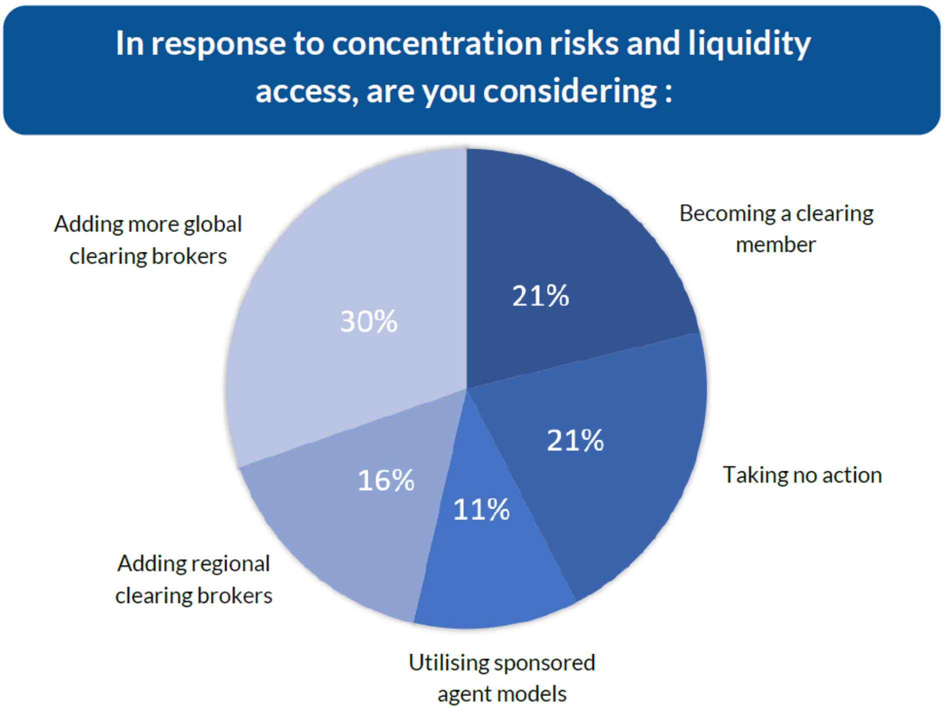
Perspective Type	Current CCP Access	Access Type	Brexit Type	Change	Suggested Action
European end user	Global CCP	UK-based clearing broker	Hard	• Onshore (EU-based) CCP • Move to onshore clearing broker	• Option 1 – Move to onshore clearing broker with access to onshore CCP • Option 2 – Take direct or sponsored membership at onshore CCP
			Medium		
			Soft	No change	No change
European end user	Global CCP	Direct member	Hard	Use of onshore CCPs	Take direct or sponsored membership at onshore CCP
			Medium		
			Soft	No change	No change
Non-European end user	Global CCP	Non-EU based clearing broker	Hard	• Onshore CCP • Move to local clearing broker	• Option 1 – Take direct or sponsored membership at onshore CCP • Option 2 – Take on local clearing broker in order to access European market
			Medium	No change	No change
			Soft		
Non-European end user	Global CCP	Direct member	Hard	Use of onshore CCPs	Take direct or sponsored membership at onshore CCP
			Medium	No change	No change
			Soft		

Table 3 – Brexit clearing implications for derivatives end users

Source – Sernova Financial

BREXIT AND CLIENTS

In the past, clients looked at several key factors when choosing a clearing broker and clearing house, such as liquidity, product breadth, currencies, capital resources, reporting capability, service levels, relationship strength and costs. Once the numbers of clearing brokers began to dwindle, just being able to maintain capacity and access became critical. However, new factors need to be considered now, such as the location of the clearing broker and clearing houses they can access.



Graph 3 – Response to concentration risks

Source – DerivSource Webinar questionnaire – "CCP Clearing – How is the Market Evolving?"

More end users are looking for a local clearing provider to hedge against global bank retrenchment. In addition, clearing houses are introducing more methods of accessing the CCP that can reduce the risk faced when clearing through the traditional clearing broker route.

For example, Eurex has introduced ISA Direct that enables clients to clear like a direct member with reduced financial support from a clearing broker. This means that end users can be more confident that they will keep their collateral and positions in the event of a clearing broker default.

Many banks are looking for or have already taken full direct membership. Direct membership significantly reduces market access risk and the cost of being closed out in the event of a clearing broker default. There is also a growing interest among buy-side firms to gain direct access to a clearing house, and many are actively working on the right structure that would enable their membership.

More regional clearing brokers coupled with more direct clearing members would go a long way in reducing the concentration risk that exists in clearing and ultimately could help reduce systemic risk in capital markets.

CONCLUSION

The globalised nature of finance is being replaced by one that is becoming more localised and is being confounded by the disappearance of 'global elite' participants. The world is moving from having established global financial centres towards economic nationalism, whereby governments seem to exert a heavy influence over their respective domestic economies. As a result, in the event of either a 'medium Brexit', where the primary driver is essentially the protection of the national banking system, or 'hard Brexit' that seeks to primarily protect currency risk, we could expect both a major geo-political ramification as well as reciprocities from other G20 members.

In a clearing context, these events would translate in two possible ways: the emergence of a global CCP with regional risk pools (i.e. both global liquidity and localised risk management controlled by the local regulator), or alternatively, the appearance of a number of new regional clearing houses. In either case, we are heading towards a reshape of the clearing geographic by moving from a few global CCPs to many regional ones, with a demand for certain 'bridging solutions' between them.

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