Euro “clearing”: Liability and Location

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This issue of `clearing’ is likely to come to a head quickly once Article 50 Notice of `intention to leave’ is served by the UK - as a direct consequence of the G20 commitment to ensure there are no more taxpayer-funded bailouts of EU financial institutions. Post Brexit, Eurozone Member States are likely to be very concerned about capital market activities denominated in euro that – in a crisis – could create liabilities for their taxpayers. At that stage, UK-based financial firms will not be subject to EU law and therefore outside the ECB’s ability to enforce any necessary managerial change – unless the UK agrees to surrender control to EU institutions.

However, it is very disturbing to an outsider that, eight years after the Lehman crash, there are still good grounds for concern in a systemic crisis– especially flowing from the “clearing” of euro:

- ESMA 2016 stress test “A CM defaulting in one CCP would also be considered to be in default in all CCPs, in which it is a member, leading to more than 25 CM defaulting EU-wide…”
- The Commission’s December 2016 CCP Resolution Proposal “No Member State has yet developed a full national regime for CCP recovery and resolution which fully complies with the G20-endorsed FSB principles, including as regards the need for effective coordination and oversight against cross-border spill-overs.”

The magnitude of the risks are extraordinary: The key interest rate contracts cleared in the UK are more than 50 times UK GDP, and 10 times the Eurozone’s GDP. Put starkly: €117 trillion of euro derivatives may have to be supported by liquidity based on the ECB’s €0.011 trillion capital and that of National Central Banks. Any resultant credit losses would be a major political concern for Eurozone taxpayers, governments and Parliaments.

Does the EU27/ECB need to “do” anything further about Brexit? The ECB’s post-Brexit re-statement of its “oversight policy” provides a powerful analysis – implicitly - of the post-Brexit situation when it would have no powers to “induce change” in critical offshore financial market infrastructures. Once the Article 50 Notice has been served, all UK firms will be fully aware that their “EEA Authorisation” will expire at the moment of Brexit so they will need to make their own plans to continue their EU business.

The working assumption must be that the UK will not be a part of the European Economic Area (EEA) so any bespoke arrangement (normally taking the form of a Treaty) may require significant adjustment to many EU Directives and Regulations. The much-discussed “transitional arrangements” for UK firms might not be “in force” before 2023, given the necessary legislative processes. As risk-averse clients recognise the new risks, they may exercise their freedom to move their derivative positions to CCPs in a market where they can have a high degree of confidence that the ECB would supply liquidity in a crisis.

A major loss of derivatives business could worsen the UK’s balance of payments deficit by a third from its current record deficit - even at modest profitability levels for the derivative book. Parliament should require the BoE to analyse and publish the balance of payments implications in detail.

(This article summarises a 22-page report that is available here)