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Euro clearing could continue from London post-Brexit, but with EC supervision

By Sophia Furber

The European Commission's latest move to control the clearing of euro-denominated derivatives is a shot across the bow of London's dominance of the business, but industry observers say it is premature to speculate about the end of the city's reign as a world leader for clearing, and that the U.K. and the EU are likely to find a compromise involving some level of increased industry supervision.

The EC confirmed May 4 that it is preparing proposals for new legislation that could threaten London's status as the global leader for the clearing of euro-denominated derivatives after Britain leaves the EU. Options under consideration include requiring that euro clearing be done from within the EU, the *Financial Times* wrote, although the U.K. could also receive so-called regulatory equivalence that would allow clearing to continue under the existing framework.

Tighter EU regulation of clearing that takes place in London is the third option being weighed. A decision on how to proceed is expected by late June.

EU's doubts long-standing

London is the linchpin of euro-denominated clearing, accounting for 74.9% of all transactions, according to 2016 data from the Bank of International Settlements. Derivatives clearing has become a point of contention in Britain's negotiations with the EU as it prepares to leave the bloc, with the EU suggesting that it will impose territorial restrictions on the clearing of euro-denominated swaps after Brexit.

On its own, a migration of clearing would not hugely damage London's standing as a financial capital, although if it prompted large chunks of the city's investment banking business to join the exodus, that would be a far bigger blow. But for Sean Tuffy, senior vice president at private financial services firm Brown Brothers Harriman, reports earlier in the week that the EC was to move once more to repatriate euro clearing to the eurozone were neither particularly dramatic nor concerning.

"Even before Brexit, the EU was uncomfortable with the U.K.'s dominance in euro clearing," he said via email. "This week's reports indicate that the EU Commission is looking at enhanced supervision of clearing outside of the EU. This could even mean U.K. clearing houses being directly supervised by EU regulators. However, this sort of arrangement isn't unheard of. For example, the U.K. has granted U.S. regulators oversight of large U.S. clearing operations in the U.K. Obviously, the devil will be in the detail. But the status quo can't survive Brexit. If enhanced regulatory cooperation is the outcome, I'd suspect the U.K would be OK with that."

Some $574 billion of euro denominated derivatives were cleared daily in London in April 2016, compared with $101 billion in France, $7 billion in the U.S. and $1 billion in Hong Kong, according to BIS data.

How far is too far?

There is a limit to how far the EC will be able to restrict activity in London after Brexit, said Simon Gleeson, a partner at Clifford Chance and specialist in banking and financial markets law and regulation.

"Post-Brexit, what the European parliament does cannot affect the U.K. in any way. So talking about imposing restrictions on derivatives trading in London is the wrong way to look at it," he said in an interview. "The question is should they [the EC] impose penalties on EU businesses clearing derivatives in London. The trouble with imposing penalties is that it looks like gratuitous self-harm. These markets are in London and they are not going anywhere, so if you impose extra requirements or penalties on European banks, all you are doing is hurting the European banking system."

London is likely to remain "the primary financial center" for the clearing of derivatives in euros, and in this case, it is "right and reasonable" that Europe should have some kind of oversight given the interconnected nature of the derivatives market, Gleeson said.

However, according to Masoud Zabeti, head of the finance & banking disputes group at law firm Mischon de Reya, the EC appears to be serious about encouraging derivatives-related business to leave London, rather than attempting to regulate the industry from afar.

"It seems to me that this is just the start of preparations to gain control of that euro clearing market," he said in an interview. "I'm not even sure that the U.K. would accept regulation over this segment of the market anyway, but there are still so many unknowns at the moment."

On the subject of whether restrictions on euro clearing would lead to an exodus of banks from London, Zabeti said institutions affected would most likely be considering a move anyway, given that it remains unclear whether U.K.-headquartered banks will retain the passporting rights that allow them to do business freely across the EU.

ECB President Mario Draghi warned in January that Brexit would lead to a loss of supervisory powers of U.K.-based derivatives clearing houses by Europe, and called for solutions to "at least preserve or ideally enhance" the existing level of oversight.

The ECB has previously tried to require that all derivatives clearing houses handling euro-denominated trades be based in the eurozone, but was overruled by the European Court of Justice, which said Britain's EU status meant that London had the right to equal treatment.