

Editorial

Brexit Challenges and Solutions for EU Financial Markets

Matthias Graulich

After the financial crisis, the G20 committed to bringing over-the-counter (OTC) derivatives markets towards more transparency and collateralization against risk exposures. In particular, central clearing via Central Counterparties (CCPs) has thus become the corner stone of risk management in financial markets. CCPs calculate risks in real-time, demand adequate collateral, and guarantee the fulfillment of transactions. Consequently, one crucial element for CCPs' ecosystem is an efficient supervisory setup.

This becomes especially evident when we look at OTC interest rate derivatives (IRD) as the largest derivatives market in the world: Clearing and risk management of these products are essential for the real economy and financial stability. IRD are closely interlinked with the monetary and liquidity policy of central banks and they are used by the buy-side to hedge against interest rate risks affecting their business.

Brexit Challenges for Systemically Important Clearing Activities

The UK currently acts as a wholesale hub for the

EU accounting for almost 80% of its financial market activity. As regards IRD denominated in the EU's currency – the most important currency in the OTC IRD market next to the US Dollar – even more than 95% are currently cleared at the London Clearing House (LCH). Amidst the significant volume in question, Brexit will lead to a situation in which a CCP with systemic importance for EU financial stability will operate outside the umbrella of EU regulation and supervision – ultimately leaving EU supervisors and central banks without appropriate tools for intervention.

This is why EU regulators are discussing how to enhance the EU's ability to manage potential systemic risks, which may result from Euro-denominated financial products cleared outside the EU jurisdiction: Joint supervision and location requirements for systemically important third-country CCPs.

Limits of Joint CCP Supervision When Financial Stability Matters Most

As regards joint supervision by EU authorities and the home supervisor of a third-country



Matthias Graulich
Member of the Executive Board
Eurex Clearing

CCP, cooperation is of course beneficial under fair weather. However, conflicts of interest might appear quickly in a crisis scenario. Then, a stabilizing measure from the perspective of the home supervisor might go against our interests from the EU perspective. This illustrates well the limits of joint supervision, entailing a right of information but no decision-making or enforcement powers for EU authorities. Relocation might be the only regulatory tool to ensure that the CCP in question is appropriately supervised and decisions by EU authorities can actually be enforced.

Establishing a Market-Led Solution for a EU27-Based Clearing Alternative

March 2019 is getting closer and a hard Brexit cannot be ruled out. It is more important than ever to get prepared now. In order to assist the market and regulators alike to cope with the unprecedented uncertainty around Brexit, Eurex Clearing, one of the world's leading CCPs, has developed a partnership program together with major participants in the IRD market. While we fully agree with the desire of

EU regulators that OTC IRD denominated in Euro must be cleared within the EU going forward, we believe that a market-led solution to develop a liquid, EU27-based alternative is preferable over any forced relocation. Our program has gained broad market support with 29 sell-side firms from the US, the United Kingdom, Asia, and Continental Europe on board and a strong increase in market share to 8% in May 2018 from close to nothing last year. Most importantly, we can observe a level playing field in OTC IRD execution prices. Bid-offer spreads for Eurex Clearing and LCH-cleared transactions which were assumed to drive adverse effects on EU end clients are essentially the same now, nullifying any concerns around price quality and costs for the industry. By establishing a competitive, efficient market-led solution, clients and the broader market place can benefit through greater choice and competition, improved price transparency and quality, as well as greater robustness of financial markets, bringing the EU closer to the G20 objective of strengthening financial stability.