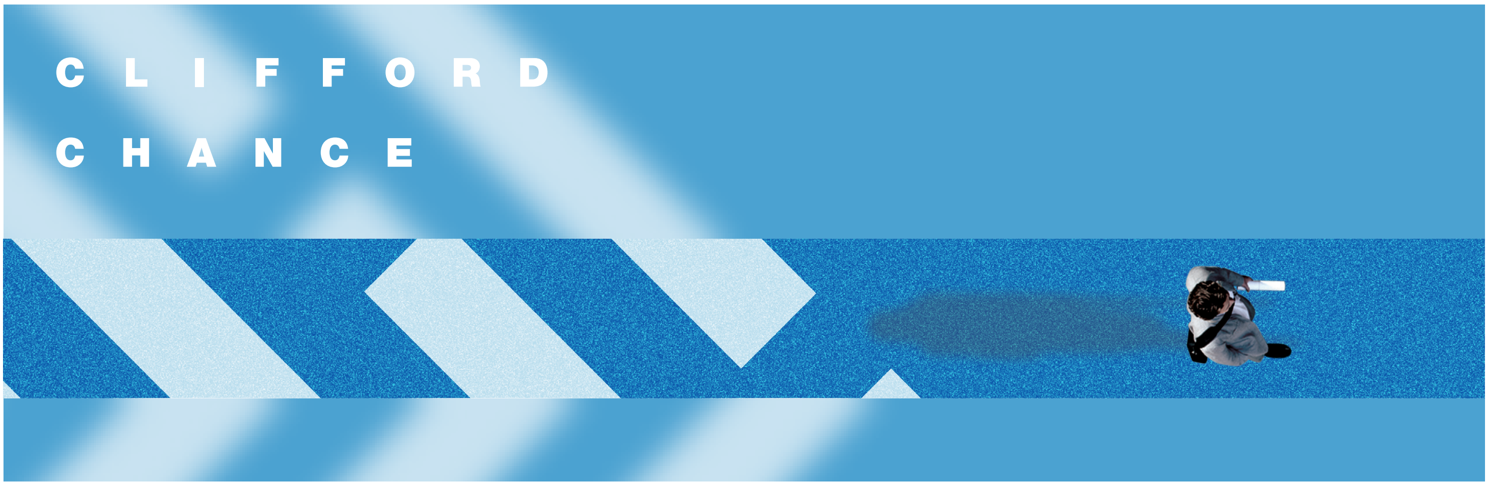

EUROPE HOLDS THE CARDS ON CLEARING YET BOTH SIDES CAN PROFIT

There is encouragement for those who fear that Brexit will diminish the City's status

Clearing houses do three big things. They estimate the likelihood that a member will default and take collateral from them against this. They manage a default when it happens, and they mutualise the costs of that default.

If all goes to plan, the collateral taken at step one will be enough to soak up the losses on default at step two, and there will be no residual losses to distribute at step three. If it doesn't, mutualisation of loss through the clearing house may be the only thing standing between a single substantial default and market meltdown. This is why clearing houses are important, and why derivatives clearing was a plank of the G20 post-crisis reforms.

In order to be effective, mutualisation requires loss transfer from those who are doing badly to those who are not. Distribution of loss among people who have all been affected in the same way by the same external event is useless — if you were a farmer in hurricane alley, you would not rely for your protection on a scheme entirely underwritten by other farmers in hurricane alley. In clearing, multi-market, multi-currency, multi-product clearing houses are plainly optimal in diversifying risk. The more broadly based the clearing system, the safer the financial system that it clears.

Viewed from a systemic perspective, then, breaking up clearing houses by forcing euro clearing to take place in the EU is a cost with no benefit. This is why so many are so puzzled by the idea that the EU wants to fragment clearing across the European market into smaller pools of more closely correlated risks. The truth, of course, is that it wants no such thing.

The essence of the EU proposal is to allow the London and Chicago-based clearing systems to continue intact, provided that they submit to a degree of EU regulation and supervision: inspections; compliance; rules and fines. The incentive to comply is continuation of their current right to free market access across Europe, allowing euro clearing to go on in London as it does today.

The threat accompanying this offer is that, if it is not taken up, the global clearing houses will be excluded from the EU. This is in many respects an unpersuasive argument, since the primary negative impact would be on EU banks, which would face increased costs. But it should not be disregarded.

It has long been a truism that if London wishes to remain the financial centre of Europe, it must give Europe a fair say in its regulation. If the UK authorities refuse to recognise the legitimate concerns of the EU in the regulation of the City, they should not be surprised if steps are taken to try to remove euro trading from London. The fact that such steps will harm both the UK and the EU will be regarded as unfortunate but unavoidable collateral damage.

Conversely, the fact that Brussels is prepared to concede that access to EU markets in financial services may be granted to non-EU companies that subject themselves to its supervision is an enormous and significant concession. Even more importantly, the EU proposal is based on a "substituted compliance" approach. This means that companies that agree to EU oversight may be released from any obligations in this direction provided that they comply with local rules, and that these rules are accepted by the EU to be equivalent to its rules. In short, although regulatory authority ultimately sits with the EU, on a day-to-day level this would be delivered by local regulators.

The direction of travel here is immensely encouraging for all those who are concerned that Brexit will significantly diminish London's status as Europe's financial centre. The model of the EU encouraging London's success, provided that it feels it has sufficient say in its regulation, could well prove not only to be beneficial for the derivatives market, but also exemplary for other financial sectors.

This article by London partner Simon Gleeson was originally published in the Financial Times on 14 June 2017.

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