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The European Derivatives Market after Brexit

The Brexit will affect the stability of derivatives markets. These markets are huge and global, but they concentrate on the financial hub London. This article discusses post-Brexit scenarios for the financial supervision of these important markets and recommends to strengthen the supervision at the EU-level.

Derivatives are financial instruments which allow the hedging against risks. Their importance for risk management is not limited to financial firms. Exporting firms want to hedge against adverse developments in exchange rates, resource-processing firms want to hedge against risks from increasing commodity or energy prices and the hedging against weather related risks is necessary in agriculture, power supply and transportation. Firms that have borrowed money at a variable rate loan can use derivatives to exchange uncertain future interest rate payments against fixed rate payments.

Markets Concentrate on London

The derivatives markets are critical to the stability of the financial system. Data from the Bank for International Settlements (BIS) reveals that the global volu-

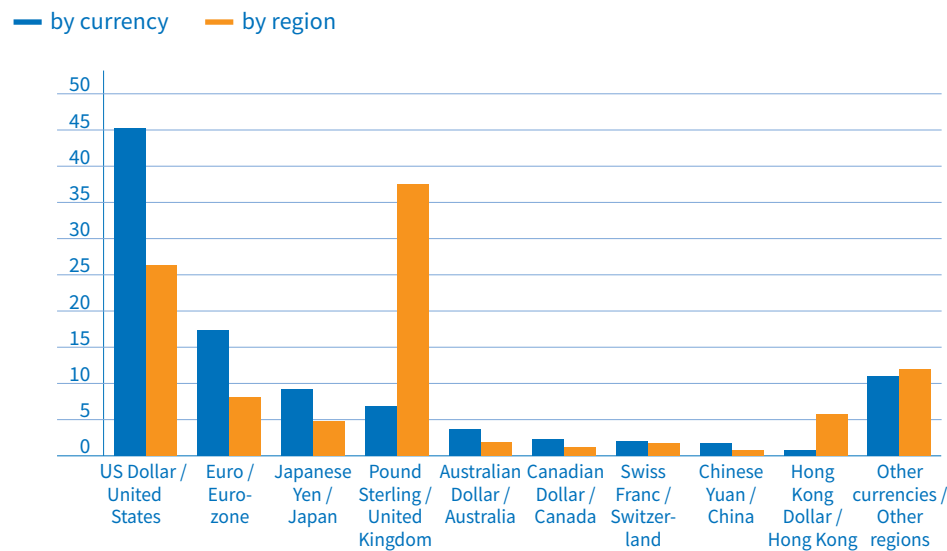
me of derivatives in the first half of 2016 amounted to more than 600 percent of the global gross domestic product and that the majority of the volume (89 percent) is cleared in over-the-counter (OTC) markets. From the European, and even the global, perspective London is the most important financial hub for the clearing of OTC derivatives of all major currencies. While 38 percent of the volume in 2016 was cleared in the UK, only 7 percent was denominated in Pound Sterling. Around 45 percent of the volume of derivatives was denominated in US-dollar and 17 percent in Euro, while only 26 percent was cleared in the US and only 8 percent is cleared was the Eurozone (figure). Thus, a large part of Euro denominated contracts are cleared in London. Due to the large concentration of the European clearing activities in the UK, the London-based clearinghouses are of utmost importance to the stability of the EU's financial markets.

Clearinghouses are Infrastructure

A response to the global financial crisis was to promote the clearing of OTC derivatives through central counterparties, also called clearinghouses. Based on this, clearinghouses became critical market infra-

Foreign exchange and interest rate derivatives turnover by region and currency

In per cent of the total turnover



Sources: Bank for International Settlements, Cologne Institute for Economic Research



structure. The European Commission therefore proposed new rules for the recovery and resolution of central counterparties in order to increase their resiliency in times of financial stress (COM, 2016).

The Brexit is critical to the EU's financial stability, because in the current supervisory framework there is no direct supervision of clearinghouses at the EU-level. Firms that supply clearing services in the EU need to be authorized by the European Securities and Markets Authority (ESMA) under the European Market Infrastructure Regulation (EMIR), while national regulators are responsible for the day-to-day supervision of EU-based central counterparties (ESMA, 2017). That means that a large part of the EU's clearing activities are currently supervised by the Bank of England and the UK Financial Conduct Authority. Moreover, clearinghouses from third-countries, e.g. the US, which supply their services in the EU, are still subject to the supervision of their home country (ESMA, 2017). Thus, the EU's national supervisors are dependent on the cooperation with the third-country supervisors. In the post-Brexit environment, the UK authorities will be third-country supervisors.

Three Scenarios

For the discussion on a possible reform of financial supervision in the post-Brexit environment, three scenarios are possible for European derivatives markets:

- Scenario 1: Derivatives clearing relocates to the remaining EU27 after Brexit. In this case the national competent authorities, e.g. the BaFin in Germany, have to supervise larger markets. But it is questionable whether supervisory practices will be uniformly applied by all national supervisors and how the national supervisors share information about cross-border counterparty risks among each other. For a level playing field in the EU, a closer cooperation between the different national supervisors at the EU-level would then be needed.
- Scenario 2: London remains the most important financial hub for derivatives markets after Brexit. In that case the bulk of the clearing activities is still conducted in London and thereby outside the realm of the EU's supervisors. The EU's supervisors

then depend on a close cooperation with the Bank of England and the UK Financial Conduct Authority. Problematic would be that the clearing of derivatives in Euro is conducted outside the EU which makes the European Central Bank (ECB) reliant on the arrangement with the Bank of England to exchange Euros for Pound Sterling in case of liquidity shortages (Brunsden, 2017). That means, that in a post-Brexit environment the ECB would have to provide emergency liquidity to clearinghouses which are not supervised by EU-authorities.

- Scenario 3: London remains a global financial hub for derivatives and London-based clearinghouses establish subsidiaries in the EU. London-based clearinghouses will then be third-country financial firms, which would have to be recognized by ESMA of the equivalence of their legal and supervisory arrangements with title IV of EMIR (ESMA, 2017). But they will be supervised by the UK authorities, and not by EU authorities (ESMA, 2017). Under this scenario critical market infrastructures would operate in the EU without being directly supervised by EU authorities.

Supervision Has to Adapt

Due to the global nature of OTC derivatives markets, their huge size and their systemic importance, it would be difficult to ensure financial stability, if the supervision of these markets will lose effectiveness after Brexit. In all three above discussed scenarios the current supervisory framework has to be reformed in order to achieve a closer cooperation and collaboration between the 27 national supervisors, as well as with third-country supervisors. Besides the reforms of ESMA's governance structure and the scope of its mandate as proposed by Sapir et al. (2017), ESMA should also be strengthened as the macroprudential supervisor of the EU's derivatives markets, while conducting the day-to-day supervision in close cooperation with the national authorities. ESMA should be responsible for promoting supervisory convergence and for ensuring financial stability and financial integration in the EU. Therefore, ESMA

has to be more involved in the direct supervision of third-country clearinghouses by a closer cooperation with the relevant third country supervisors. A possible avenue is the proposal of Sapir et al. (2017) to give ESMA extraterritorial supervisory capacity for third-country clearinghouses that have systemic relevance for the EU. In the post-Brexit environment, the clearing of Euro denominated contracts has to be supervised by EU authorities. The EU has to find a solution that excludes supervisory loopholes in these important markets.

The resiliency of derivatives markets is crucial for financial stability and after the central clearing obligation this resiliency depends on the resiliency of clearinghouses. The Brexit will reshape these markets. But irrespective of which post-Brexit scenario will materialize, financial supervision at the EU-level has to be strengthened in order to guarantee safe and transparent derivatives markets.

Literature

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