Markets

Key Brexit Clash Would Cost Euro Swap Traders $2.4 Million a Day

By Silla Brush
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- Dutch professor estimates cost of fragmentation of clearing
- Permission for cross-border clearing expires in June next year

Commuters walk along London Bridge. *Photographer: Jason Alden/Bloomberg*

One of the biggest Brexit battlegrounds between the European Union and the U.K. now has a price tag: at least $2.4 million a day.

That's how much any move by the European Union to cut off access to London's dominant clearinghouses for derivatives could cost traders in euro interest rate swaps, net of buying, according to an estimate from Albert Menkveld, professor of finance at Vrije Universiteit Amsterdam, who has sat on advisory panels to European regulatory authorities.

Fragmenting cross-Channel clearing would result in additional costs because global dealers would need more collateral for their positions in multiple clearinghouses in the U.K. and in the EU, Menkveld said. They wouldn't be able to offset, or net, the positions as easily and that would require dealers to raise extra funds.

Those additional costs would likely be passed on to pensions, money managers and other users of derivatives in the local jurisdiction, Menkveld said, who compares the burden on financial markets to traffic jams caused by passport controls.

"This is the price we all paid for control by national authorities," Menkveld wrote in a blog post. "As a European citizen I can now zip onto the Autobahn at 100-plus kilometers per hour, but my pension fund might soon pay for crossing the border with the U.K. to diversify risk."

His tally is one of the first to show the immediate fallout if authorities stop the seamless, cross-Channel settlement of trillions in euro interest rate swap contracts, which currently takes place largely in London. The actual cost could be far greater if it weakens London's attractiveness as a global financial center. The business is widely viewed as a core pillar of London's standing and the EU's desire to pull more of that business away has prompted sabre-rattling from politicians, financiers and even the governor of the Bank of England.

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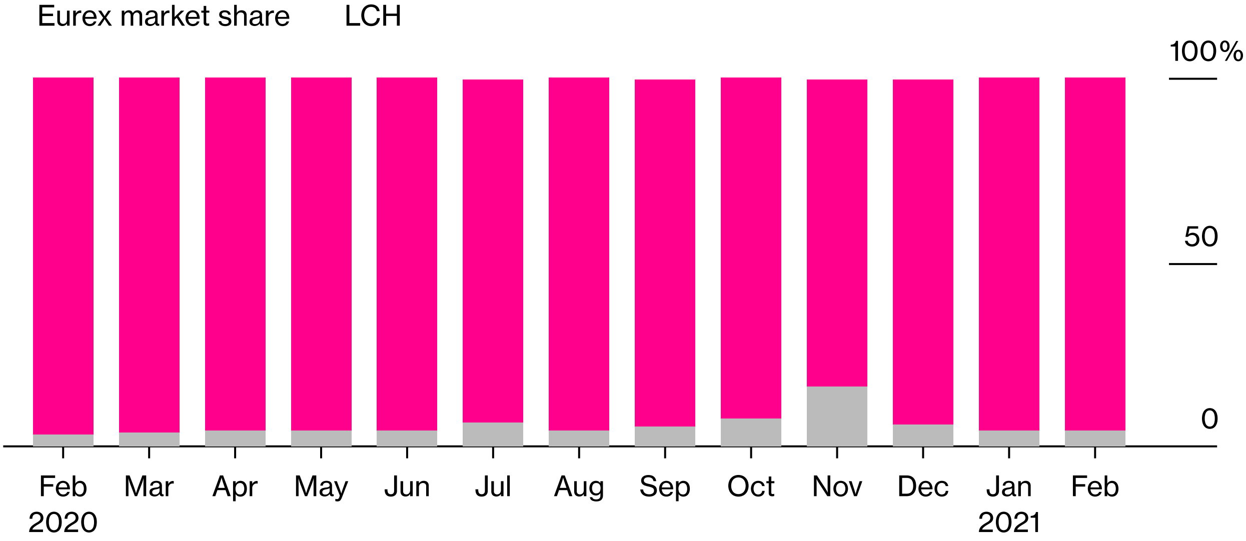
The U.K. and major lobby groups for the biggest banks and money managers in the world are calling for the EU to maintain easy access to London clearinghouses, including the London Stock Exchange Group Plc's LCH unit which is the world's biggest for euro interest rate swaps. The European Commission in Brussels wants the bloc's traders to move more of their euro-denominated business inside the EU and not rely so heavily on London. A ruling last year extended access to London through June 2022.

Clearing Prize
London's LCH clearinghouse dominates euro interest rate swap market



Source: Clarus Financial Technology
Note: Market share is for cleared notional business

Clearinghouses serve as a key hub in the global financial system, settling hundreds of trillions of dollars in deals between banks, hedge funds, pensions and a wide range of corporations. The firms collect collateral, or margin, from buyers and sellers to reduce the risk that the default of one side spreads panic to the other and, in turn, across the broader system.

If the temporary decision isn't renewed, Bank of England Governor Andrew Bailey has said a quarter of euro-derivatives clearing business would need to shift to the EU. The rest would likely stay in London because it is currently the most efficient place for it, he said.

Additional Costs

The estimated net price impact probably understates the total additional costs to traders in the market from the disruption that would ensue, Menkveld said.

Costs could mount because traders would probably have a harder time offsetting positions in euros, pounds and other currencies as well as the increased compliance burden. In more stressed markets, traders could face much higher costs from the split and difficulty using clearinghouses in both the U.K. and the EU, he said.

"There is a trade-off here between the benefits of local control by regulators, and the additional costs that fragmented clearing imposes," Menkveld said. "The benefit is hard to quantify but the costs are non-trivial."