Union Investment Working Paper

Perspectives on the implications of an EU27-Relocation for Euro Swap Clearing

Perspectives on the implications of an EU27-Relocation for Euro Swap Clearing

Abstract

The over-the-counter (OTC) market for interest rate derivatives is the largest financial derivatives market in the world. Compared to other currencies, the Euro-denominated OTC interest rate derivatives market, primarily cleared in London, is currently the second largest market. A relocation of the Euro clearing to the EU27 reduces costs for asset managers substantially and strengthens the stability of the European financial system.

Contents

1. Strengthening the stability of the EU financial market and increasing efficiency 4

2. Assumptions regarding proclaimed additional costs need to be questioned 6

3. Changes in market structure and volumes ensure efficiency within the EU27 7

4. Significant cost benefits within the EU27 10

5. Conclusion 13

References 14

1. Strengthening the stability of the EU financial market and increasing efficiency

A relocation of the Euro clearing to the EU27 is imperative for the stability of EU financial markets and will not endanger Euro clearing efficiency

The over-the-counter (OTC) market for interest rate derivatives is the largest financial derivatives market in the world, with a volume of around EUR 240 trillion.[1] In this market, asset managers, insurance companies, hedge funds as well as small and mid-sized banks (so called "buy-side") use interest rate swaps[2] to hedge against interest rate risks. Most of these interest rate swaps are settled via central clearing houses ("CCPs")[3]; therefore, the clearing of Euro-denominated swaps ("Euro clearing") is essential for the buy-side and an integral part of the European economy. A majority of the clearing and risk management for Euro-denominated interest rate swaps is currently conducted in London: About 82% of all interest rate swaps settled via CCPs and even 96% of the respective Euro-denominated interest rate swaps are settled at the London Clearing House (LCH).[4]

In contrast, the relocation of the Euro clearing to the EU27 would make use of the infrastructure already existing in some EU27 countries. At Eurex Clearing, for example, legal and technical requirements for the clearing of interest rate swaps have already been fully complied with and all relevant market participants have been linked.

---

1 BIS, semiannual OTC Derivatives statistics, December 2016, adjustment of the key figure of the Bank of International Settlement (http://www.bis.org/statistics/derstats.htm) of EUR ~ 350 Trillion by deduction of double-weighted interdealer volumes (c.f. Clarus FT, https://www.clarusft.com/moving-euro-clearing-out-of-the-uk-the-77bn-problem/); exchange rate on 30 December 2016: 1.0541 USD/EUR (Deutsche Bundesbank)

2 Interest rate derivate at which contractual parties agree to exchange interest payments on fixed nominal amounts at a certain time in the future. Interest payments are usually set in a way that one party pays an interest rate fixed at the closing of the deal while the other party pays a variable interest rate.

3 CCPs (Central Counterparties) act as neutral counterparties in financial transactions. For the seller, they act as a buyer whereas for the buyer, they act as a seller of a contract. As a result, CCPs reduce credit risk in trading, since they guarantee the fulfillment of a contract even if one party defaults.

4 June 2017, Clarus FT, https://www.clarusft.com/moving-euro-clearing-out-of-the-uk-the-77bn-problem/

Portfolio analyses show that margin[5] efficiencies can generate positive effects in the form of initial margin[6] and financing savings: This is achieved by cross-product margining of Euro-denominated exchange traded and OTC derivatives[7] at an EU27 CCP as well as by efficient collateral management. The aforementioned margin and collateral efficiencies should exceed potential marginal, temporary cost increases caused by a wider bid-offer spread.[8] Asset managers should therefore benefit from significant cost savings from a Euro clearing in the EU27.

---

[5] Margin is the collateral to be deposited by a Clearing Member (in the form of cash, funds or securities) for the purpose of fulfilling a contract and is based on the risk position in the respective portfolio. It thus serves to cover the risk of the clearing house and to settle all open positions of a Clearing Member at minimum time. Margining describes the process of measuring, calculating and managing deposited collateral.

[6] The initial margin represents the collateral margin that is based on the current market value of a portfolio and that is deposited at a clearing house to cover possible additional settlement costs.

[7] Exchange traded derivatives are referred to as "exchange traded derivatives" ("ETDs") and over-the-counter derivatives are referred to as "over-the-counter" ("OTC").

[8] Difference between bid and ask offer that also serves as a common measure for the assessment of money and capital market efficiency.

2. Assumptions regarding proclaimed additional costs need to be questioned

Underlying assumptions regarding proclaimed additional costs need to be corrected

The current debate on the relocation of the Euro clearing postulates high additional costs for market participants: Additional initial margins between USD 30 billion and 77 billion are expected, corresponding to an increase of 40 to 100%[9], or an increase in trading costs over a period of five years amounting to more than USD 100 billion.[10] However, according to the European Commission the underlying assumptions for these figures are "very doubtful" and lead to "unrealistic hypothesis and scenarios". Cost calculations by the European Commission predict an additional initial margin of only EUR 6 to 10 billion. The European Commission also points out that the initial margin is rather deposited collateral than an expense for market participants. Costs only arise from the financing of the initial margin: Assuming an initial margin increase of about EUR 6 to 10 billion at 50 basis points, real financing costs for the entire industry would amount to EUR 34 to 50 million.[11] It has to be noted, however, that these numbers provided by the European Commission – just like all other calculations mentioned above – are based on an EU28 reference framework, therefore do not consider a new, post-Brexit market structure or the potential of netting efficiencies resulting from clearing OTC and ETD positions through an EU27 CCP. In a new market equilibrium that would be shaped by a combination of different financial products in one currency rather than one financial product across different currencies, at least today's netting effects should be realized and therefore no additional costs should occur.

[9] Based on the initial margin of USD 83 billion in mid-2016.

[10] Data taken from Clarus FT: "Moving Euro clearing out of the UK: The $77bn problem?": https://www.clarusft.com/moving-euro-clearing-out-of-the-uk-the-77bn-problem; Data taken from LSE, Bloomberg: "LSE Raises Estimate for Loss of London Clearing to $100 Billion": https://www.bloomberg.com/news/articles/2017-05-22/lse-raises-estimate-for-loss-of-london-clearing-to-100-billion; Data taken from AFME/ BCG/ Clifford Chance,: "Bridging to Brexit: Insights from European SMEs, Corporates and Investors", p.8: https://www.afme.eu/globalassets/downloads/publications/afme-bcg-cc-bridging-to-brexit-2017.pdf

[11] European Commission, Impact Assessment accompanying the EMIR Review Proposal from 13 June2017, p. 63 ff.

3. Changes in market structure and volumes ensure efficiency within the EU27

Changes in market structure and increasing volumes within the EU27 ensure efficient portfolios

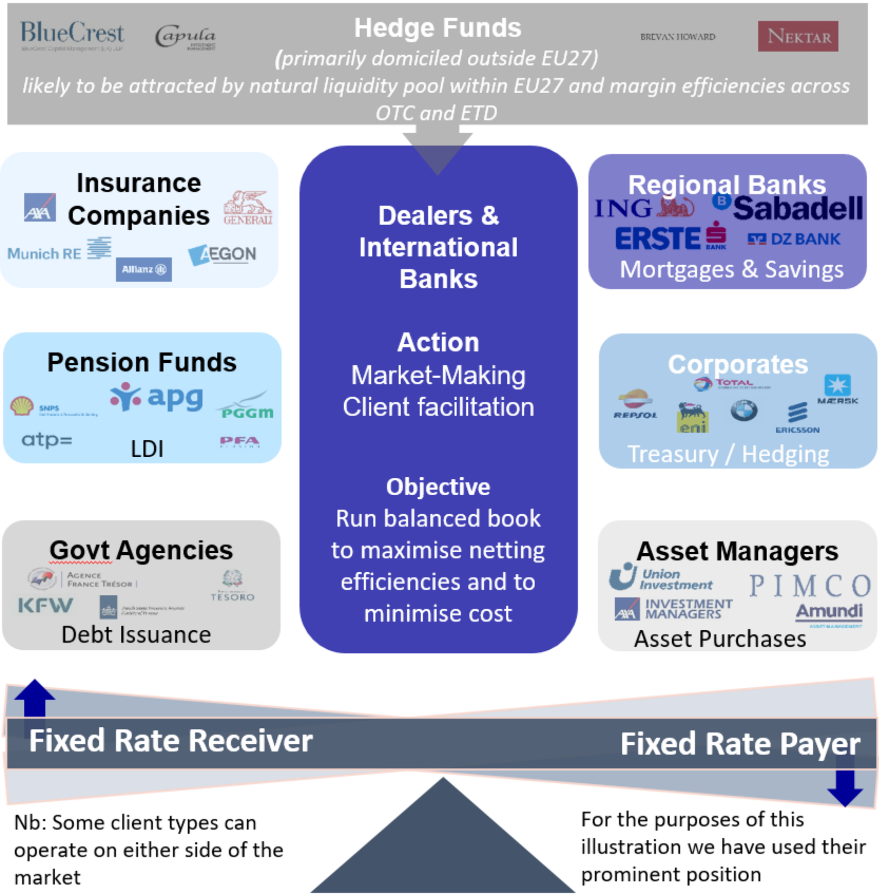

Figure 1: EU27 OTC derivatives system
Spource: Eurex Clearing AG

The EU27 OTC derivatives ecosystem provides not only a sufficient size, but also the necessary balance of fixed rate payers (regional banks, corporations and asset managers) and fixed rate receivers (insurance companies, pension funds and public-sector entities) required by large globally operating dealers to manage efficient, balanced portfolios.

With a share of approximately 30%, the Euro-denominated OTC interest rate derivatives market currently represents the second largest market compared to other currencies.[12] A significant share of that market is not yet cleared through CCPs and therefore holds enormous growth potential.[13] In the medium term, the volume of EU27 market participants will increase for the following reasons:

- Numerous companies within the EU27 are not yet obligated to clear transactions through a CCP, since the clearing obligation for Category 3 counterparties will not take effect before July 2019[14] and temporary exemptions to the clearing obligation remain for certain market participants. Category 3 or exempted counterparties include many asset managers and insurance companies or pension funds that manage large directional swap portfolios.

- Due to the low interest rate environment, activities of market participants in Euro-denominated swaps decreased, as many market participants had less need to hedge against falling interest rates. Given a normalized interest rate environment in the Euro zone, activity in Euro swaps should increase significantly, particularly by EU27 participants.

- The vast majority of globally operating dealers acting as trading partners for EU27 customers is currently located outside the EU27. However, they would be asked to clear within the EU27 if a clearing obligation was introduced and they intended to continue offering their services to EU27 customers. Due to the substantial increase in market activity and liquidity and since especially hedge funds benefit from netting efficiencies across ETD

[12] Based on OTC IRD global notional amounts outstanding based on currency, BIS semiannual OTC Derivatives statistics, December 2016.

[13] By the end of 2009, approximately 36% of all OTC interest rate derivatives were cleared through a CCP. By the end of 2015, the share had already grown to 60% (European Commission, Impact Assessment accompanying the EMIR review proposal dated 13 June 2017, annex 2, p. 78).

[14] Commission Delegated Regulation (EU) 2017/751: "(EU) 2015/2205 (2), (EU) 2016/592 (3) and (EU) 2016/1178 (4) determine 4 categories of counter parties for the purposes of setting out the dates on which their respective clearing obligations take effect. Counterparties are categorized according to their level of legal and operational capacity and by their trading activity in relation to OTC derivatives. In order to ensure a timely and orderly application of the clearing obligation, staggered phase-in periods were applied to those different categories of counterparties."

and OTC, end-customers located outside the EU27 should be inclined to move their business to an EU27 CCP. In the long run, inter-dealer hedging transactions would most likely transfer to the EU27 as well in order to manage Euro-denominated portfolios as efficiently as possible.

4. Significant cost benefits within the EU27

The buy-side can achieve significant cost benefits by clearing within the EU27

For asset managers within the EU27, costs of swap transactions consist mainly of initial margin costs as well as clearing broker fees (approx. 70% of total costs). With about 20%, only a small share of total costs is attributable to the bid-offer spread and only about 10% to CCP fees.

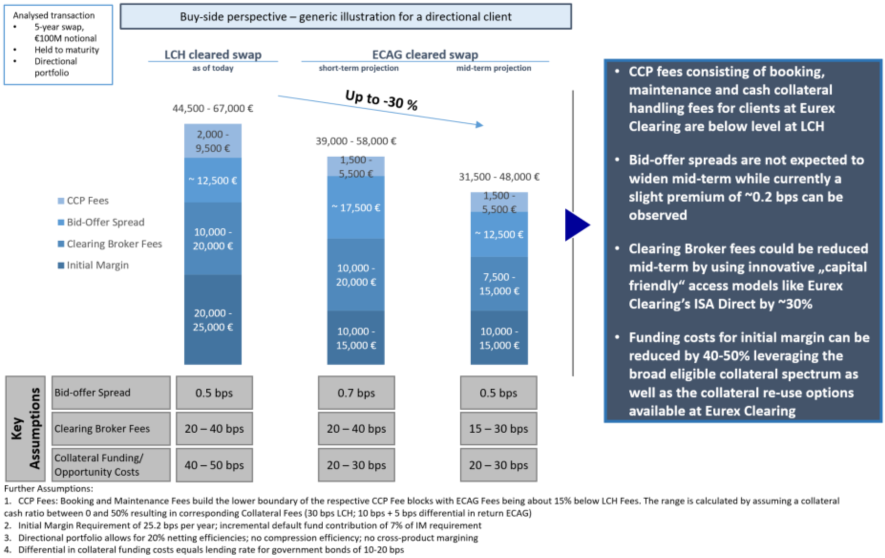

Figure 1: Buy-side costs – generic illustration of costs components for a directional client
Source: Own calculation based on portfolio data with support from Eurex Clearing AG

Most relevant cost components from an asset manager's perspective

- A relocation will reduce initial margin costs for asset managers substantially. In terms of increased initial margin costs, as mentioned in the beginning, cross currency netting effects are significantly overestimated and optimization potentials for market participants resulting from an alternative composition of existing liquidity pools through a relocation of the Euro clearing is not sufficiently accounted for. Optimization potential lies in the settlement of Euro-denominated ETD and OTC transactions via one single platform, e.g. the OTC Euro-denominated swaps book containing Euro-denominated ETD or repo transactions. Unlike the common assertion, asset managers should witness positive rather than negative effects resulting from the relocation of the Euro clearing.

It can also be expected that financing costs will be reduced when clearing through a EU27 CPP operating with a banking license and broad collateral spectrum. Nearly all interest rate swaps are currently cleared via LCH in London and have to be collateralized with cash or government bonds. As a result, asset managers are required to hold corresponding cash buffers or may not use government bonds for any other purposes, e.g. securities lending. Lower investment levels and a lack of securities lending income reduce returns for asset managers.

The broader range of permitted collateral is complemented by the possibility to re-use securities from other financial transactions ("collateral re-use"). An EU27 CCP, such as Eurex Clearing, which offers the clearing of various asset classes like derivatives and securities financing transactions provides the basis for theses efficiencies.

The overall **cost benefit resulting from the collateral spectrum** can be rated with **at least 10-20 basis points**. For example, opportunity costs for the clearing at LCH would be significantly higher compared to Eurex Clearing, should the latter allow the use of securities while LCH only allows the use of cash due to the availability of collateral.

- A significant amount of **clearing broker fees** is driven by leverage ratio induced capital costs. Innovative clearing models can reduce these capital costs and therefore cut clearing broker fees up to 30%. Such models are already offered within the EU27, for example by Eurex Clearing.

- The **bid-offer spread** serves a dealer as an instrument to cover capital and financing as well as operational costs and to realize profits – approximately 20% of the bid-offer spread covers a dealer's capital, financing and CCP costs. These costs mainly stem from leverage ratio induced capital costs. The bid-offer spread for 5-year interest rate swaps is currently at about 0.5 basis points. Assuming that the entire volume of EU27 clients is concentrated in one EU27 CCP, experts see no evidence to suggest a lasting widening of the bid-offer spread in the medium term. Therefore, a relocation of the Euro swaps business to the EU27 should not affect trading costs for the buy-side.[15]

- Regarding **CCP fees**, for example, transaction related fees for asset managers are on average 10 to 20% lower at Eurex Clearing compared to LCH. Additionally, fees for cash collateral management at LCH exceed respective fees at Eurex Clearing by approximately 15 basis points.

- Overall, these statements show that a clearing obligation within the EU27 would result in cost reductions for asset managers.

[15] Based on analyzes taking into account the current volume in interest rate swaps at Eurex Clearing, a widening of the bid-ask spread of around 0.2 basis points would be justified on a calculatory approach. Initial margin netting effects in dealer accounts are already up to 99% at Eurex Clearing.

5. Conclusion

The EU27 offers ideal conditions for an efficient Euro clearing.

Asset managers would benefit from a relocation of the Euro-denominated interest rate swaps business to the EU27 due to substantial and sustainable cost savings of up to 30%. These cost savings should more than compensate for possible temporary additional costs caused by a wider bid-offer spread.

Thus, from an asset manager's point of view, substantial advantages would arise from a clearing within the EU27, as it results in cost reductions while at the same time strengthening the stability of the European financial system.

References

Bank for International Settlements, Semiannual OTC Derivatives Statistics

Boston Consulting Group/AFME Finance for Europe/Clifford Chance, “Bridging to Brexit, Insights from European SMEs, Corporates and Investors”

Clarus Financial Technology, “Moving Euro clearing out of the UK: The $77bn problem?”

EU Commission, SWD (2017) 246 final, “IMPACT ASSESSMENT Accompanying the document Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorization of CCPs and the requirements for the recognition of third-country CCPs”

Imprint

Publisher
Union Asset Management Holding AG
Weißfrauenstraße 7
D 60311 Frankfurt am Main
Phone: +49 69 2567-2066 or -2235
E-Mail: Public.Affairs@union-investment.de
Internet: www.union-investment.de

Editorial: Executive Board Office (V. i. S. d. P.)
Layout/Graphics: Union Investment Holding AG, Figures 1 and 2 with support from Eurex Clearing AG

Disclaimer