

## Brexit

# US eyes prize in Brexit battle over derivatives

New York could be 'big winner' from EU-UK swaps tussle, says Morgan Stanley chief



*The processing of derivatives worth \$1.2tn a day, denominated in a variety of currencies, is emblematic of London's global standing as a financial centre © Bloomberg*

5 HOURS AGO by: **Philip Stafford**

In the post-[Brexit](https://www.ft.com/topics/themes/Brexit) vote stand-off between London and Europe one flashpoint is the City's prized swaps business. Faced with a less certain future on both sides of the English Channel, the market is now asking whether the US will ultimately emerge as the prime destination for derivatives.

That's being floated by one leading Wall Street bank with James Gorman, chief executive of Morgan Stanley, [questioning](http://next.ft.com/content/40851fd2-8da5-11e6-a72e-b428cb934b78) whether Europe has the infrastructure required for Wall Street swap dealers. New York could be "the big winner" from a battle between the UK and EU, Mr Gorman reckons.

Trading and clearing of derivatives like swaps is one of the businesses most emblematic of the City's global standing as a financial centre, with London processing \$1.2tn a day of deals denominated in a variety of currencies. Euro-denominated swaps account for just over [half the total](http://www.bankofengland.co.uk/statistics/Documents/bis-survey/fxotcsum16.pdf), according to the Bank of England.

The financial crisis of 2008-09 only emphasised the importance of clearing derivatives. A clearing house stands between two sides of a deal and manages the fallout of a default. Strengthening their role has been a pillar of global policymakers' efforts to reinforce markets since the crisis.

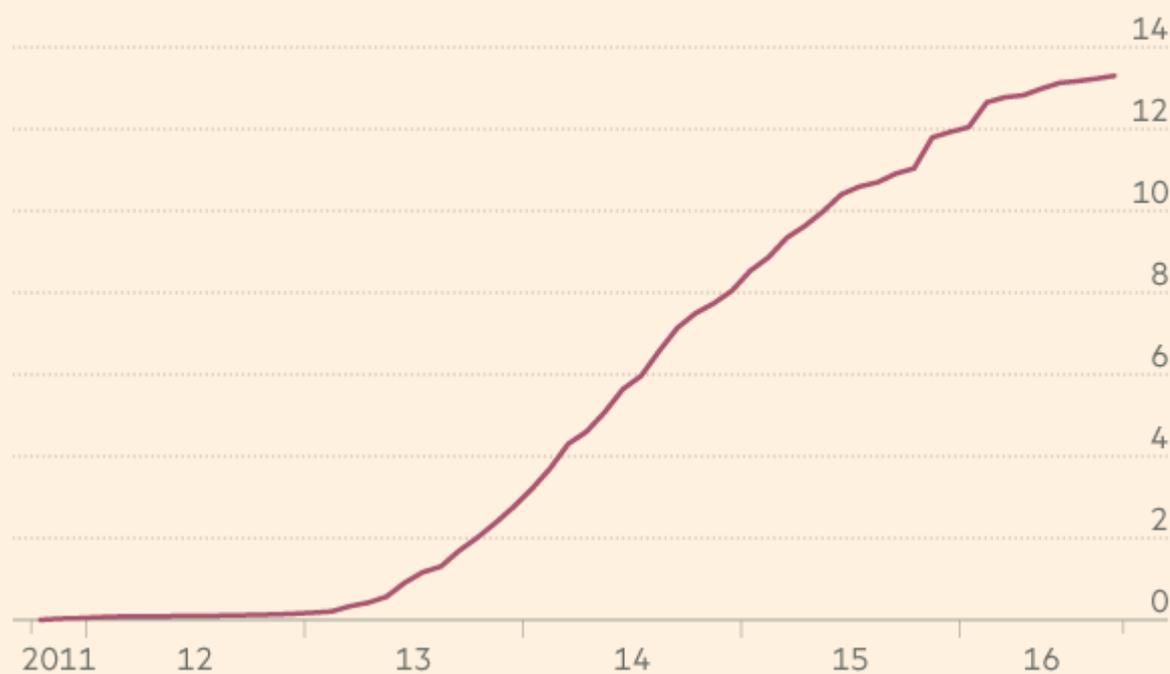
François Hollande, the French president, and Michel Sapin, his finance minister, have seized on the Brexit vote to strengthen their calls for swaps denominated in euros to [shift](http://next.ft.com/content/e8e0c44a-3d89-11e6-9f2c-36b487ebd80a) from London to within the EU.

That would require an EU treaty change enabling the European Central Bank to mandate clearing in the bloc. A similar attempt by eurozone countries was foiled by the UK at the European Court of Justice in 2015.

However, any efforts by European politicians to engineer such a shift in the landscape for clearing derivatives is seen as leaving the US as the chief beneficiary. That reflects a desire among market participants to clear derivative trades in a jurisdiction that can handle large amounts of activity and also provide attractive legal standards.

### Euro-denominated swaps gain traction in the US

Interest rate swaps cleared at CME (€tn)



Source: CME Group

FT

Like London-based clearing house LCH, US rivals CME Group and [Intercontinental Exchange](http://markets.ft.com/data/equities/tearsheet/summary?s=us:ICE) also process swaps denominated in multiple currencies. The US superseded the UK as the world's largest centre for over the counter interest rate derivatives activity in September, BIS data showed.

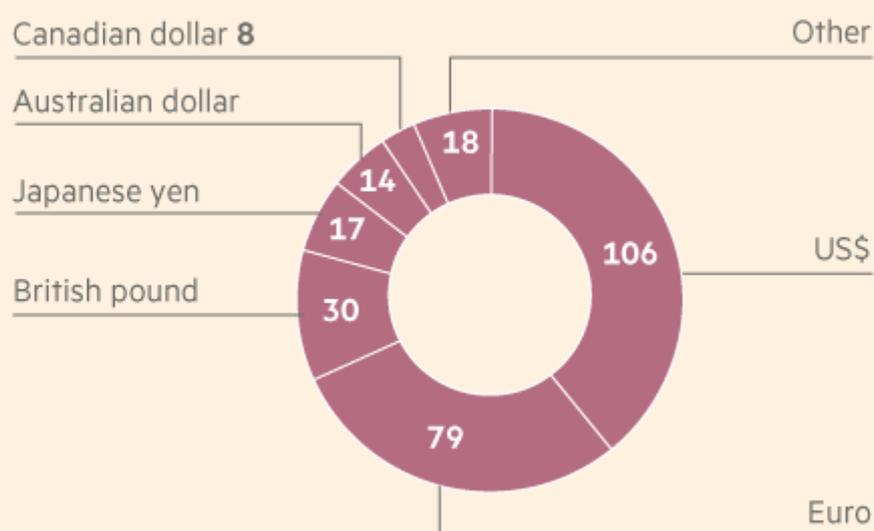
In Chicago, the CME has cleared €13.3tn over the past three years, and is managing around €2.3tn in euro-denominated open positions. While that pales besides LCH's business in London, the US has [secured equivalence \(http://next.ft.com/content/b7f72eda-cfef-11e5-92a1-c5e23ef99c77\)](http://next.ft.com/content/b7f72eda-cfef-11e5-92a1-c5e23ef99c77) in clearing standards with Brussels — something the UK hasn't.

“The only other financial centre in the world that could clear all these currencies centrally and efficiently is New York,” warns Xavier Rolet, chief executive of the London Stock Exchange Group, which controls LCH, the world's largest interest rate swaps clearing house. He also points out: “Why would the UK settle for less than the US's mutual recognition arrangement for clearing houses?”

Sir Jon Cunliffe, the BoE's deputy governor for financial stability, says a policy mandating euro swaps to be cleared in the EU would fragment the global clearing framework.

### Clearing volumes at LCH

Notional outstanding by currency, to Oct 17 (\$tn)



Source: LCH

FT

“If we extrapolate — then dollar contracts would have to be cleared in US, and sterling here and the yen in Japan ... you make multicurrency infrastructure impossible,” he told UK lawmakers last week. “If we fragment clearing, the costs will go up across the system.”

Banks and other holders of swaps claw back some of the outlay on margin payments for their derivatives trades by concentrating them at only a handful of clearing houses and netting down their positions.

“If you separate euro-denominated clearing from the larger liquidity pool, you lose some of these efficiencies — and ultimately cost the customer money,” warns Mr Rolet.

For the industry, fragmentation may require a near doubling of the initial margin it posts for trades, from \$83bn to \$160bn, estimates ClarusFT, a financial data company.

In recent years, clearing houses have also been heavily involved in “[compressing \(http://next.ft.com/content/1af0d63e-4e42-11e4-adfe-00144feab7de\)](http://next.ft.com/content/1af0d63e-4e42-11e4-adfe-00144feab7de)”, or tearing up, so-called offsetting derivatives contracts held with them. Deals with notional values amounting to trillions of dollars are made redundant because two positions are hedged perfectly.

LCH cleared close to \$600tn of OTC derivatives in 2015, compressing \$328tn. That equated to at least \$25bn, it estimated, in regulatory capital saved for banks, and their clients such as manufacturers and energy companies.

Craig Pirrong, a finance professor at the University of Houston, says: “Sir Jon is making a very basic point. There are substantial economies of scale and scope in clearing.”

#### Related article

**[François Hollande rules out City’s euro clearing role \(http://next.ft.com/content/e8e0c44a-3d89-11e6-9f2c-36b487ebd80a\)](http://next.ft.com/content/e8e0c44a-3d89-11e6-9f2c-36b487ebd80a)**

French president moves to strip London of crucial stage in derivatives and equities trading

He adds: “[Fragmentation] will also lead to serious issues in a crisis, because it will necessitate co-ordination of responses across more clearing houses, operating under different legal and regulatory frameworks. That could be very tricky.”

Others fear forcing euro-denominated swaps clearing [into the EU \(http://video.ft.com/5109851378001/Brexit-s-effect-on-derivatives-clearing/Markets\)](http://video.ft.com/5109851378001/Brexit-s-effect-on-derivatives-clearing/Markets) looms as a policy with no real winners.

“This extends beyond London. As a global reserve currency, there is growing concern in the markets that the euro may no longer be freely tradable and clearable,” says Walt Lukken, chief executive of FIA, a derivatives trade association.

As the head of clearing at one investment bank in Europe, says, the issue looks straightforward: “No one’s explained to me: what is specific about euro-denominated swaps that it has to be cleared in that jurisdiction?”

*Additional reporting by Mehreen Khan*

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