Investment News

Monthly Bulletin from the Insurance & Investment Team

July 2017

Last Month in Brief

The 2017 General Election resulted in a hung parliament, with no party having an overall majority. The pound fell around 2% against the US dollar following the result, a change which has been attributed to the uncertainty caused following the general election result. The pound has fallen more than 14% against the US dollar since last June's Brexit vote.

The Bank of England voted to keep interest rates at 0.25% for an eleventh consecutive month as had been expected by economists. The vote by the Monetary Policy Committee was closer than expected with a 5 - 3 vote in favour of keeping the rate at 0.25%. The close vote has largely been attributed to the higher-than-expected inflation of 2.9% in May, up from 2.7% in April and close to a four-year high. The value of the pound rose against both the euro and the US dollar in response to the vote but later fell back against the US dollar. The Bank of England has stated the fall in the pound could cause inflation to rise above 3% in the autumn, and remain above its 2% target.

The OECD forecasted that the global economy growth rates will rise to 3.5% in 2017 and 3.6% in 2018 from a recent low of 3% in 2016, its lowest since 2009. Following a weak first quarter for the US economy, the OECD has revised down its US GDP growth forecast for 2017 from its November prediction of 2.3% to 2.1%.

Chart 1: Equity Indices
Equity markets were stable over the month, EMU falling at the end of the month.

Chart 2: Sterling Credit Spreads
Credit spreads narrowed over the month

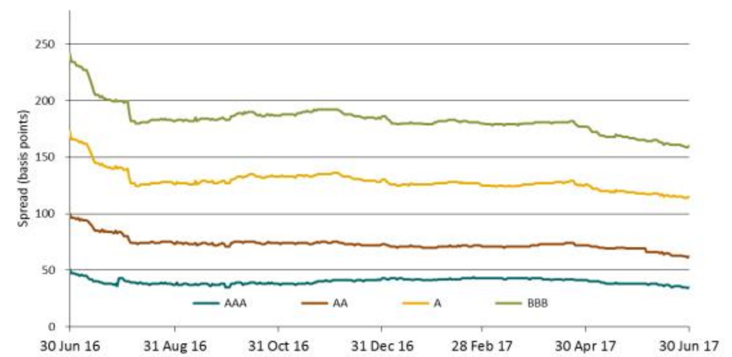


Chart 3: Gilt Yields
Nominal gilt yields were stable over the month

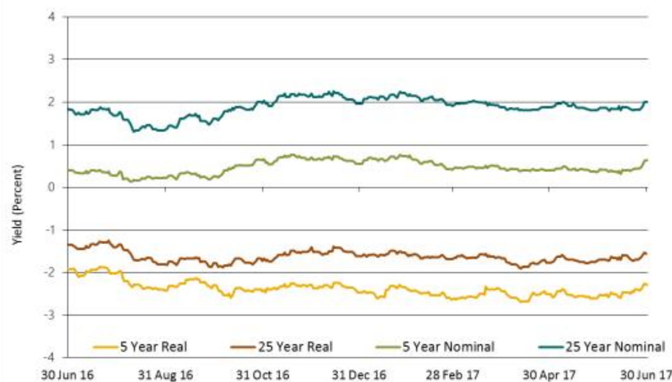
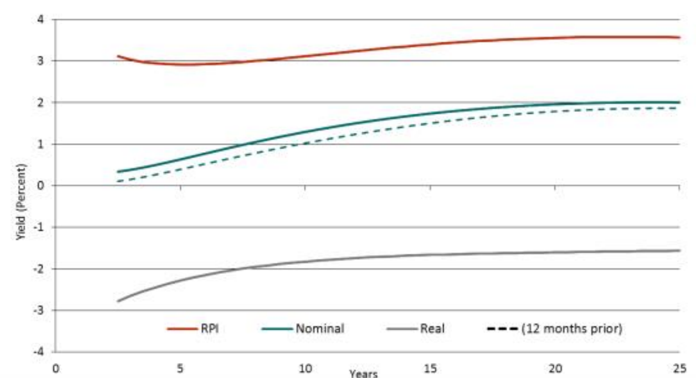


Chart 4: Gilt Spot Curves*
The yield curve remains upward sloping



** Data for the real and inflation gilt spot curves prior to 1st January 2017 is temporarily unavailable from the Bank of England*

Source: Financial Times, MSCI, Merrill Lynch Bank of America and Bank of England. Note real gilt yields are not displayed this month as their calculation methodology is under review.

	Latest	Previous		Latest	Previous
CPI (annual change)	+2.9%	+2.7%	**Base rate**	0.25%	0.25%
PPF 7800 funding ratio	86.8%	86.0%	**$/£ exchange rate**	1.30	1.29
Halifax house prices (monthly change)	-1.0%	+0.4%	**VIX (volatility) index**	11.18	10.41

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Euro Clearing

What is clearing?

One area of uncertainty following Brexit is around London's role in euro clearing.

Clearing is the mechanism in which a third party organisation, a central counterparty clearing house (CCP), acts as an intermediary and assumes the role of both buyer and seller of financial contracts and derivatives to reconcile transactions between the two parties.

A CCP reduces risk for traders by protecting both the counterparty trader and the rest of the market if a trader defaults on payment by acting as a counterparty to all trades and therefore a guarantor if one party fails to uphold their part of the agreed deal. For certain instruments the CCP requires each party to a trade to deposit a percentage of the price of securities with the CCP when the deal is agreed, this is known as the initial margin. Additional payments from the traders to account for any adverse price movements, this is known as variation margin. By doing this a CCP removes the credit risk for the two trading parties and controls its exposure to the trade.

Additional benefits of clearing are:

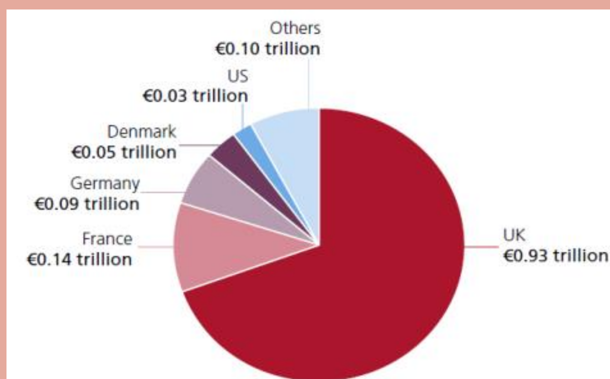
- Multilateral netting of risk exposures
- More rigorous risk management practices than many traders
- The potential for enhancing market transparency

For euro clearing, these contracts are tied to the underlying value of a financial instrument on behalf of member firms or participants, where these transactions are denominated in euros.

Where is clearing carried out?

For one component of euro clearing, interest rate derivatives, the London Clearing House (LCH) says it clears €927bn of contracts a day. The City has approximately 70% of the business while Paris, London's biggest rival, has 11% (see figure 1). London is a world market leader for the clearing of all types of currency-denominated financial instruments, due to the general acceptance of English law. London dominates the euro clearing market but this dominance has been threatened by proposals from the European Central Bank (ECB) following the UK referendum vote on 23 June 2016 to leave the European Union.

Figure 1: OTC interest rate derivatives markets trading in euros, daily turnover. House of Lords publication 2016 - Brexit: financial services



Why do the EU want control over euro clearing?

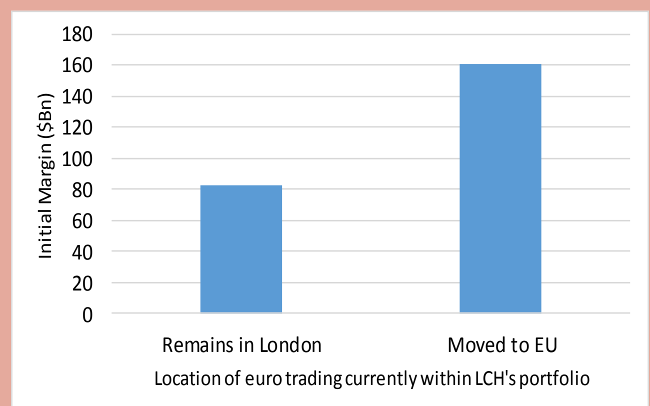
Depending on the outcome of the Brexit negotiations the UK may leave the single market, in which case the EU might have less influence over how the clearing houses in London are regulated and scrutinised. The consequences of a failure of a London based clearing house could be significant for the EU. European regulators argued that LCH aggravated the Eurozone's sovereign debt crisis in 2011 by raising its margin requirements on debt for Spain and Ireland. In 2011 the ECB insisted that all euro trades were done inside the Eurozone. However this was overruled by the European Court of Justice which said the European Central Bank did not have the legal power to do so. HM Treasury argued that this would discriminate against non-Eurozone countries who are part of the EU.

What would it mean if UK lost this trade?

The European Commission now proposes that EU regulator European Securities and Market Authority (ESMA) should be given powers to assess overseas clearing houses. Clearing houses will be vetted on the basis of their size, structure and how much of their business is in EU currencies. Those that are adjudged to pose a "systemic risk" to Europe's financial stability will have to adhere to a range of requirements which makes them compliant with European Market Infrastructure Regulation (EMIR).

Figure 2: Estimated effect of moving LCH to Europe.

Data Source: Clarus Financial Technolgy Group - www.clarusft.com



According to the chief executive of the London Stock Exchange, Xavier Rolet, a proposed move could cost investors. Rolet references a study by Clarus Financial Technology Group (Clarus) which states that if the clearing component of LCH's business were to be split, as would be the case if the euro clearing was transferred from London to within the EU, the initial margin requirement for traders would almost double from $83bn to $161bn (see figure 2). The additional cost to the financial services industry of $77bn of additional margin is due to moving the clearing activity to a new Eurozone clearing house which would not benefit from the existing diversification benefits that the LCH has with its other clearing operations.

Opponents of the European Commission's proposal state that if euro-denominated transactions are conducted in the Eurozone, a disjointed and less competitive market would lead to higher costs for European customers. The London Stock Exchange Group, majority shareholder in LCH, says that a smaller domestic pool of trading would make trades less efficient. It also argues it would be harder for the members of a smaller pool to absorb any losses and says risk would therefore increase not decrease.

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