Europe might gain from Brexit, but still lose to Asia

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Author
Orçun Kaya
+49(69)910-31732
orcun.kaya@db.com

www.dbresearch.com

Deutsche Bank Research Management
Stefan Schneider

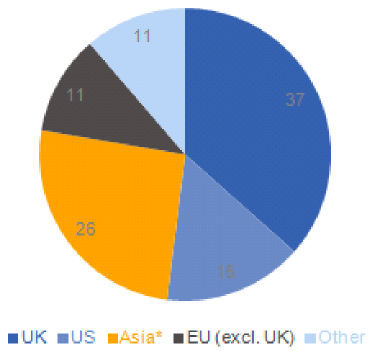
Regulatory reforms have already reshaped derivatives trading in Europe. The upcoming potential shift towards central clearing for some derivatives classes and the availability of CCPs globally will likely result in some fragmentation in derivatives trading. FX derivatives markets are providing first insights into this: Asia already makes up 26% of global FX derivative trading volumes in 2016. As the Asian exposures of European firms and Asian financial sector grow, hedging currency risks in local Asian markets seem to be becoming common practice. This may fuel the ongoing decentralisation of global derivatives trading and give rise to higher costs for market participants.

Regulatory reforms have been reshaping derivatives trading in Europe and globally. With G20 agreement in 2009, standardised derivatives transactions are required to move to central clearing counterparties (CCPs) that stand between trading parties. What is more, not cleared trades will be subject to higher capital requirements. In line with the G-20 reforms, central clearing services have been offered not only in Europe but also on other regions such as in Asia. Indeed, five of the G-20 countries are located in Asia, and in addition Hong Kong and Singapore have voluntarily signed up to the G20 commitments. Of the currently operating CCPs for interest rate and foreign exchange (FX) derivatives six and two are located in Europe respectively. Meanwhile seven of the CCPs for interest rate derivatives and four of the CCPs for FX derivatives are located in Asian financial hubs. Moreover, a large number of CCPs located in Asia are authorised by the US and EU authorities to clear trades for US and EU counterparties. This implies that US and European banks will be able to tap CCPs located in Asia to clear their positions for Asian trades. These have important implications for European derivatives markets such that Europe might gain some market share from Brexit, but still lose to Asia.

FX derivatives market provides first insights to shed some light into these implications. Indeed, FX derivatives have assumed an important role in global derivatives markets with a notional outstanding volume of USD 74 tr or 14% of all over the counter (OTC) derivatives in mid-2016, up from 9% in mid-2010. In a growing market segment, transactions are increasingly taking place in Asia: the region’s share of global FX derivative trading expanded from 20% to 26% over the same period, according to the latest triennial survey of the Bank for International Settlements (BIS). Trading in the EU made 48% of the market where the lions share come from the UK with 37%. The Japanese yen remained the most widely traded Asian currency in 2016 with a daily turnover of USD 701 bn, followed by the Chinese renminbi with USD 135 bn, up from just USD 26 bn

Asian markets play an important role in FX derivatives trading

% of total in 2016



*includes China, Hong Kong, India, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand

Sources: BIS, Deutsche Bank Research

six years ago. The general upswing is consistent with Asian markets' secular increasing profile in the global economy and international capital flows towards Asia.[1]

Between 2010 and 2015 alone, the East Asia-Pacific area saw an annual GDP growth rate of 4.1% on average (for China the figure even came to around 8%) whereas the global average was only 1.7%. This has boosted the importance of Asian currencies in international trade significantly, and hedging currency risks has become essential for counterparties such as export and import firms.

The expansion of the FX derivatives market in Asia also reflects the increased depth of local-currency bond markets, which was driven not least by the experiences of the Asian financial crisis of 1997/98. To be specific, outstanding volumes of government debt securities (short-term paper as well as longer-term bonds) in local currencies[2] grow from around 25% of GDP in 2001 to more than 40% in 2015. Likewise, local-currency corporate bonds surged from virtually zero to more than 15%. Remarkably, over the same interval, both government and corporate bonds in foreign currencies remained largely flat relative to GDP. In the meantime, global banks' cross-border exposure towards emerging Asia-Pacific countries tripled between Q2 2005 and Q2 2016. Cross-border exposures to China alone increased more than tenfold. EU banks' Risk Weighted Assets (RWAs) in Emerging Asia made around 4 % of their total RWAs in 2015. With local currencies assuming an increasing role in Asian financial markets, mitigating exchange-rate risks became crucial for market participants such as European banks.

Despite the growing role of FX derivatives in the market as a whole central clearing has been limited in this segment and unlike other derivatives classes. Indeed, rules on uncleared FX derivatives positions are not fully implemented yet but higher capital requirements will probably incentivise market participants to move towards CCPs in the coming years. According to the Financial Stability Board, it is currently technically feasible to centrally clear for example around 20-40% of new FX derivatives transactions in China and Singapore, and even 60-80% in India. Other derivatives classes provide indications of what may happen to the FX market, too: clearing volumes are already relatively high both in interest rate and credit derivatives, around 75% for the former. In these markets, central clearing at the moment largely takes place in London. This is mostly due to netting of trades, a practice that reduces the number of transactions and the collateral needed and thereby lowers costs for clearing counterparties. Nonetheless, central clearing will probably not cluster in a single location in the future. For example, after Brexit the clearing of euro-denominated derivatives is very likely to shift to one of the euro-area countries. This will reduce netting benefits for trading counterparties and open the door for CCPs in other regions, not only in derivatives classes where central clearing is important already but also in other segments like FX. Hence, with a general decentralisation of clearing services, Asian currency derivatives are also likely to be cleared locally, i.e. mainly in domestic CCPs or in New York, in the coming years. As a result, trading in Asia will probably gain further traction and take on an even more important role globally. On the other hand, such a fragmentation will lead to lower netting benefits and higher collateral costs for market participants.

[1] For example, on 1 October 2016 the Chinese renminbi was added to the International Monetary Fund's Special Drawing Right basket of currencies that includes the US dollar, euro, Japanese yen and British pound.
[2] Local currencies of Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Thailand and Vietnam.