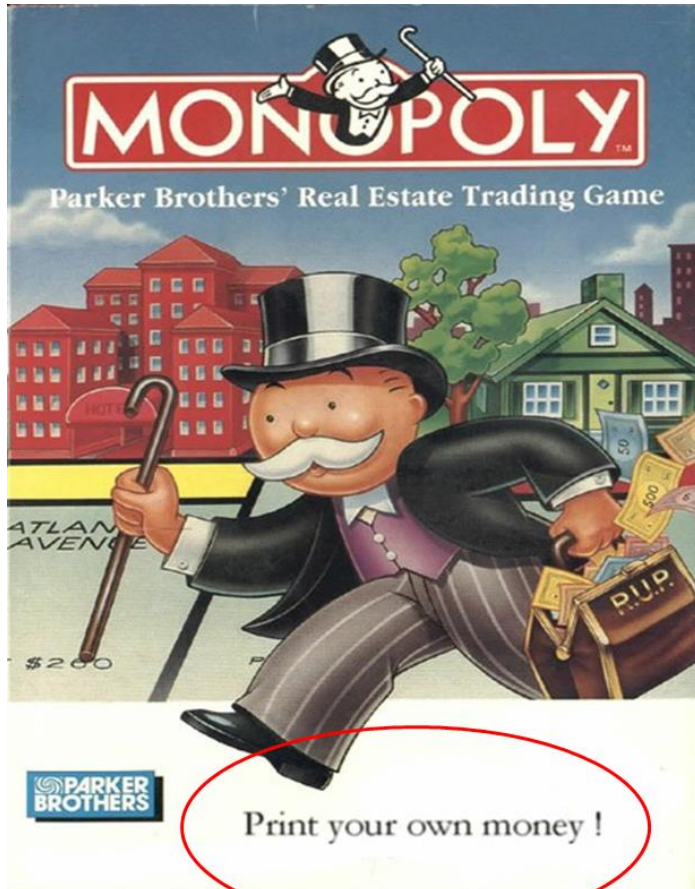




Brexit & Market Infrastructure

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Raising London's game – and the world's



“The Bank never goes broke. If the Bank runs out of money, the Banker may issue as much as needed by writing on any ordinary paper.”



Monopoly's 1935 rules predicted Quantitative Easing whereby \$20 trillion in (unsustainable) sovereign debt in 2008 has ballooned to more than \$40 trillion sovereign debt in 2016 and created some serious market challenges.

CCP Clearing

Post-Brexit the UK needs to improve control of CCP assets and resolutions.

- CCPs are always over-collateralized as Initial Margin represents a liquidation buffer.
- Mandatory margining of OTC derivatives has made CCP asset holdings huge.
- CCPs based in the UK may be forced to hold clearing assets/initial margin in overseas depositories post-Brexit.
- Agreements with foreign jurisdictions should ensure CCPs in the UK retain residual control of surplus assets in foreign depositories to recover value for UK claimants.

CCPs in the UK will require equivalence determination from EU

- Capital charge for 'equivalent' CCPs is 2% but otherwise 100% of risk exposure.
- Fragmentation of CCPs risks financial stability as destabilises multi-currency hedging, netting and off-sets

Margining & Market (In)Stability

Mandatory OTC margining globally now creates the risk of negative feedback as margin calls force selling in illiquid and price volatile markets.

- Self-reinforcing market dislocations could result from any shock: Brexit, Trump and Italian referendum results all dislocated markets more than expected because of intra-day margin calls.
- Shortages of HQLA assets due to Quantitative Easing, dealer disintermediation and hoarding for margin calls are exacerbating poor liquidity and market volatility.
- Flash crashes are ‘the new (ab)normal’ as the BIS has found liquidity, turnover and deal size are deteriorating everywhere while and political risk is rising: 12 flash crashes since 2010.

Market Depth and Price Discovery

Harmonised transparency, order-driven markets and punitive capital on trading books have discouraged market makers from providing liquidity or carrying inventory:

- Transparency vs. Liquidity trade-off so that faster post-trade transparency means lower liquidity
- Basel III, Liquidity Coverage Ratio and Leverage Ratio are all self-defeating if the value and marketability of assets is purely theoretical.
- Repo was in crisis at year-end 2016 with severe dislocations because of QE and hoarding.
- HQLAs are less high quality, less liquid and become impaired assets under stress conditions.
- Derivatives and ETFs have become alternatives to dealing in illiquid, costly underlying assets, but raise more questions about reliability of valuations when underlying assets are illiquid and price volatile.

Price discovery is becoming progressively more questionable:

- Without reliable price signaling market capitalism cannot efficiently allocate capital to productive uses.
- Capital and asset valuations are misleading if assets cannot realise balance sheet valuations in trading markets.
- Volatility, margin calls and market dislocations may discourage investor saving, hedging and investment.

Let London be a better London!

The world needs at least one deep, liquid, benchmark global institutional market

- Reject misguided harmonisation that is inappropriate to wholesale dealer markets.
- Restore the traditional pre-Big Bang role of *jobbers* – corporately separate market makers who were barred from credit, brokerage or custody of client assets.
- Require immediate trade reporting but delay post-trade publication of large value transactions to allow jobbers to work a deal off their books for a deeper, more liquid, more price stable market.
- Provide preferential capital-light treatment of jobber proprietary trading books to encourage deeper and wider inventories.
- Give asset managers of the world a reason to locate and trade in London by showing how a low cost, deep, efficient market enhances their performance.

Leverage the global preference for dealing under English Law.

Ensure CCPs and intermediaries holding in foreign depositories retain residual control of assets to prevent discriminatory recovery against UK clients and counterparties.

Leverage Emerging Technology

Geography is becoming less relevant while rule of law, predictable outcomes, and transparent performance are becoming more relevant.

Cloud computing allows globally distributed market stakeholders to interact on a common platform more efficiently.

Distributed Ledger Technologies can reshape how markets trade, exchange information, settle and reduce risks.

Shared services infrastructure and open APIs can reduce the capital costs of migration, integration and transformation.

As the world's FinTech capital, London should reward innovation that promotes collective market action to address problems and promote enlightened progress.



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