GOVT'S INDECISION ON TAX MEASURES FUELS UNCERTAINTY

ISLAMABAD: Pakistan's economic team is indecisive over the quantum of revenue measures in a bid to end the uncertainty that has stemmed from the delay in the 9th review under the International Monetary Fund programme, Dawn has learnt from reliable sources.

Tax officials' initial estimates show a generation of Rs100 billion from raising various tax rates, while the government expects another Rs100bn from the proposed flood levy. The FBR has, however, put forward its estimates before the IMF, stating that despite falling imports, the projected budgetary target can be achieved mainly because of the highest-ever inflation. An official source in the FBR told *Dawn* that the board has made initial work to raise rates of various withholding taxes, and increase rates of regulatory duty on luxury items to make additional revenue. The fund officials estimate a shortfall of Rs400bn in FY23, which the FBR has rejected. "We have shared our projections of revenue collection with the fund a few days back", the official said, adding the board has not received any reply from the IMF so far.

The World Bank is also reviewing various tax policy measures and suggesting various policy actions for implementation. The non-implementation of those policy measures could also trigger delays in the release of funds to Pakistan. On the other hand, FBR projection shows that revenue loss at the import stage will be compensated by the historically high inflation. As of today, the piling of un-cleared containers reaches more than 4,000 at Karachi ports, the source said, adding it will not only cause lesser duty, and tax collection at the import stage but also lead to a slowing down of the economy.

According to the source, there is also opposition to the flood levy because it will further add to the cost for industrialists. The super tax has already been challenged in the court, the source in the FBR said, adding FBR is hopeful to vacate the case in the apex court. And FBR estimates show no need for fresh taxation measures to fill the proposed gap. However, IMF insisted on additional revenue measures to keep the revenue collection on track to reach the projected tax target of Rs7.47 trillion by the end of June 30, 2023, a 21.5pc growth over the last year's collection.

The FBR collection rose 17pc in 1HFY23 against Rs2.929tr collected in July-December last year. This growth is much below what the government had committed to the IMF to achieve the target for FY23. However, FBR believed that the gap will be bridged when the collection from super tax is restored in the next couple of months. The gap in reporting mechanism between Pakistan and IMF did not confine only to FBR revenue collection but also include differences over the collection of petroleum development levy (PDL). The IMF estimates a shortfall of Rs300bn under the PDL in the current fiscal year. Pakistan's finance ministry estimate this shortfall at Rs50bn, which was rejected by the IMF. The flood levy to be collected at the import stage will be used for bridging the shortfall of PDL, especially from diesel. At the same time, there is complete confusion within the tax machinery over the revival of the IMF programme. "We are unaware whether talks will be resumed virtually or the IMF team will visit Pakistan", an official source further said. There is complete confusion about the resumption of talks.

Dawn 22-1-2023

AVERTING POTENTIAL PETROLEUM PRODUCT CRISIS

KARACHI: Pakistan's financial situation remains precarious, but the decrease in demand for petroleum products has reduced import needs, providing some relief for the financially constrained government.

However, the oil industry has warned of a potential fuel shortage. The government should take this warning seriously as the increased activity in the agriculture sector is expected to drive up fuel demand in the coming months. Fuel shortage at such a time could severely impact the economy.

The decline in economic activity, coupled with elevated fuel prices and diminishing automobile sales, has led to a reduction in the consumption of petrol and diesel.

A recent report of a leading brokerage house revealed a 15% and 23% year-on-year decrease in petrol and diesel sales, respectively, in Jul-Dec 2022.

In line with this trend, data of the Pakistan Bureau of Statistics indicates a corresponding decrease in fuel imports. Imports of crude oil and petroleum products such as gasoline and diesel dropped by 37% and 13%, respectively, in terms of volume in the first half of current fiscal year, compared to the same period of last year.

That has played a role in reducing the import bill and bringing the current account deficit down to $400 million in December from almost $1.9 billion a year earlier.

That being said, the big slide in imports came at a cost. This was the result of strict restrictions imposed by the State Bank of Pakistan (SBP) on the opening of Letters of Credit (LCs), which impacted various industries, ranging from automobile assemblers to foam manufacturers.

Despite being classified as an essential item, the petroleum sector has also reportedly faced difficulties in opening and settling LCs, as confirmed by an industry body.

In spite of these challenges, Pakistan has not yet faced a fuel shortage. The decrease in fuel demand has likely helped the oil industry and government prevent such an occurrence.

Ogra has also stated that the country has sufficient stocks of fuels, enough to meet 17 days of petrol and 32 days of diesel demand. However, the situation could change shortly as diesel requirement may increase significantly within a couple of months.

The demand for diesel typically spikes in April, as the harvesting season commences. This is evident from the 33% month-on-month increase in diesel sales volume in April 2022, which illustrates the significant rise in consumption that can happen in this period.

The increased use of heavy machinery, equipment, transportation vehicles such as tractors, irrigation tube wells and threshers by farmers is the main reason for this jump in demand, as they use diesel to power these machines.
This implies that diesel demand will increase within a few months. If the oil industry continues to encounter difficulties in opening LCs, this could lead to a fuel crisis. The shortage of diesel during April could negatively impact the performance of the agriculture sector – the backbone of the economy.
This critical segment of the economy came under severe stress last year due to the catastrophic floods that decimated key crops such as sugarcane, wheat and vegetables, and destroyed the livelihoods of hundreds of thousands of farmers.
Additionally, farmers across the country have been protesting against high diesel and electricity prices as well as shortage of fertilisers. Any disruption in diesel supplies could exacerbate these issues and further hinder the sector's performance.
The government should take action to ensure sufficient quantities of diesel are available in the market, particularly during the March-May period.
A breakdown in the fuel supply chain could take weeks to fix, so the government must take proactive measures to avoid such disruptions. This could include, for example, removing obstacles that the petroleum companies are facing with regard to LCs for diesel import.
The central bank needs to work in close coordination with the oil industry and the Petroleum Division.
Furthermore, the government should prioritise incentivising the domestic diesel production. As previously discussed in my columns, Pakistan has five oil refineries that can produce nearly 20 million tons per annum or roughly 450,000 barrels per day of refined petroleum products such as petrol and diesel.
These plants can meet all of the country's diesel requirements. However, due to a plethora of issues, including weak demand for furnace oil, only 60-70% of the capacity is utilised annually.
If all of the oil refineries run at maximum capacity, there may not be a need to import diesel. Instead, these plants will import crude oil, which is substantially cheaper than diesel, to produce the fuel.
This will not only shore up the domestic diesel stocks but also result in meaningful forex savings.
The government must collaborate with the oil refining industry to ensure that plants operate at maximum capacity by implementing favourable policies, providing appropriate incentives or making arrangements that ensure reasonable offtake of furnace oil.
The threat of fuel shortage is a serious matter that requires immediate attention. By taking a comprehensive approach, the government can ensure that the economy and citizens are not impacted by such a crisis.

TR 23-1-2023

HOW DOLLAR SHORTAGE HANDED EMIS 'ADVANTAGE' OVER BANKS

KARACHI: For Pakistanis, there are many faults in our banks — unnecessary documentation for basic procedures like account opening, inordinate disruptions in digital services, arcane regimes to stifle business growth and lack of appetite to facilitate users, to name but a few.

Apparently, there is an addition to the list: exorbitant exchange rates on foreign transactions. And as happens in times of volatility, the gap between interbank and open-market dollar rates — which is usually small — significantly widened amid high demand for the US currency. Commercial banks, insisting that they have to buy dollars from the open market to settle international payments, started charging rates that were way higher than the interbank rate.

Meanwhile, Electronic Money Institutions or EMIs — digital wallets of sorts that allow peer-to-peer transactions, top-ups and bill payments — somehow managed to offer exchange rates lower than banks.

A case in point is Ahmad Saeed, who made two foreign transactions on Jan 11, one through his bank account and another through his SadaPay wallet, which comes with a digital debit card. On the $3.50 transaction through his bank, he was charged Rs256.5 a dollar, in addition to Rs35.91 foreign transaction fee (4pc of the total amount), Rs8.98 advanced tax, and Rs4.67 federal excise duty (FED).

In contrast, for a transaction of $4.23 on the same platform, SadaPay charged Rs255.4 per dollar, apart from Rs18.8 as FED (1.5pc foreign exchange cost + tax) and a 2pc withholding tax (with 1pc refundable to tax filers).

That day the dollar closed at Rs228.90 in the interbank market and at Rs237 in the open market.

The trick up EMI's sleeves

Omer Salimullah, chief operating officer at SadaPay, one of the 11 EMIs that currently hold some sort of approval from the State Bank of Pakistan, told *Dawn* that his company did not have physical branches and used a modern technology stack, which allowed it to service customers at a cost lower than traditional banks, including a 1.5pc FX cost compared to 4pc by banks.

However, on the high exchange rate, he said the EMI didn't buy dollars directly since it was not an authorised dealer. "We get this rate passed on by our settlement bank," he added.

Some experts also believe that EMIs have an advantage over banks in the current scenario. “Startups operating the EMIs have different goals. They are focused on providing better user experience and growing fast. This gives them an edge with new users in Pakistan who are mostly young and will be getting their first bank accounts,” said Mubariz Siddiqui, founding partner at the startup focused law firm Carbon Law.

The EMIs are not managing a branch network and they are also not “laden with staff”, so their cost of doing business is less, he said. However, Mutaher Khan, co-founder of tech website Data Darbar, is not convinced with EMIs’ advantage in terms of low costs of doing business and believed that they were offering incentives to get more users. He reasoned that being branchless was not a very significant advantage and EMIs also incurred costs to build infrastructure, get people on board and offer customer care, etc. “If it is costing something, it means someone is paying. If customers are not paying, then the company is paying.” Besides, EMIs might have another edge over banks: capital funding. Since most EMIs are startups backed up by venture capitals, they have money to spend on such incentives, he said.

Should banks be worried?

With EMIs having a certain advantage over banks, and now five digital banks securing licences to operate, should banks be worried about losing their customers? For Mr Khan, the current scale of EMIs’ business is insignificant to dent commercial banks. As long as banks’ deposit base is secured, they won’t be threatened, he said. And even with the arrival of digital banks, there will be no real danger to the banks unless they start offering incentives that are way too appetising for the users. “If digital banks start lending or offer add-ons like profit on current accounts or better rates on saving accounts, then they can disrupt traditional banks,” Mr Khan said. For Mr Siddiqui, the arrival of new players would put existing banks under pressure and a more saturated market would lead to healthy competition.

Dawn 23-1-2023

ACCOUNT OPENING: SECP DIRECTS AMCS TO CARRY OUT DUE DILIGENCE

ISLAMABAD: The Securities and Exchange Commission of Pakistan (SECP) has directed all Asset Management Companies (AMCs) to carry out minimum due diligence for the opening of all accounts.

The SECP officials told Business Recorder here on Saturday that AMCs should conduct verification of the customer identity from Nadra as well as screening of the customer against applicable sanctions regimes (UNSC, NACTA, etc). In case of online account opening, verification of contact details/identity through One Time PIN (OTP) on the designated mobile number and/or email address of the Customer, as the case may be. Provided that requirements shall not be applicable in case of “Sehl” accounts, opened through BB/EMI service providers.

According to the SECP officials, AMC shall proceed with opening of account after the customer has successfully accessed the portal using the OTP. Account may be opened after due-diligence checks and satisfactory completion of the requirements as applicable on each Account. The opening of Sehl account shall require transfer of customer data from the platform through which customer is being on boarded while opening of Sahulat Sarmayakari accounts shall be subject to compliance with applicable legal and regulatory requirements on low risk accounts while Sarmayakari accounts shall be opened once all applicable legal and regulatory requirements for full/normal account are complied with. Further, a customer will not be able to redeem funds from account until all required verifications are completed for that account, subject to the provisions of NBFC & NE Regulations, 2008 and applicable regulatory framework.

The SECP officials added that the digital verification to conduct online face-to-face interaction on real-time basis or digital Verification of customer’s photograph/selfie shall be mandatory at all types of account opened of all high-risk customers requiring Enhanced Due Diligence (EDD) in line with AML/CFT Regulations.

R 22-1-2023

MAKING THE CUT FOR DIGITAL BANKING LICENSES

The State Bank of Pakistan has finally picked its winners of the five digital banking licenses from the 20 contenders that had tossed their hats in the ring over nine months ago. Or rather, it issued them no-objection certificates, and they will now have to undergo a long process. For those in the fintech and startup circles, this triggered mixed reactions. It was quite like a reality show where everyone had their fan favourites. If your preferred contestant didn’t make the cut, you would obviously be disappointed. On the other hand, a few winners had flooded the social media feed, just like high school kids with good grades do on results day.

The final list includes; Easypaisa DB; KT Bank — a joint venture between Fatima Fertiliser, City School, and Nigerian fintech Kuda Technologies; Hugo Bank — sponsored by courier company M&P, pharma group Getz Bros and Singaporean wealthtech

HugoSave; UAE's Mashreq Bank; and Kuwait Investment Authority's Raqami. None of the hyped fintechs, such as Dbank, Tyme or Alif, made the cut, raising the rationale behind the criteria. The main contention obviously is that how can players who have failed to incorporate any technology in their existing processes be expected to deliver digital financial services? Without naming, there's one sponsor whose existing cyber security is so bad that even someone like me can access critical customer data like addresses. But is the presence of local business groups such a bad thing? Or even surprising, given the finer details of the digital banking regulations? For example, M&P, by virtue of being a major courier company, has a strong distribution across Pakistan and already offers cash on delivery. The use case they can build for their customer segment can give a major boost to digitisation.

Similarly, Fatima Fertiliser — which also tried to get its hands on Samba Bank while its director invested in the now defunct fintech TAG — can leverage its expertise in agri and come up with a solution that caters to the underserved segment. Even otherwise, there are arguments as to why venture capital (VC) funded startups weren't such a good fit for the licenses.

First, venture funding to Pakistan has plunged sharply. In Q4-2022, only $15.15 million was raised, down more than 79 per cent year-on-year and the lowest since Q1-2020. Global investment activity also fell 63.5pc during the comparable period. How exactly would local and international sponsors have brought in the capital in such a scenario?

For instance, one of the 20 applicants actually saw a significant markdown in valuation by its key investor. Perhaps, others would have been exceptional at raising, but there's no denying the uncertainty involved, which can at least explain caution.

However, even before the slowdown began, there were some questions about whether the VC-backed companies would be such a great fit for the licenses. For anyone to become a digital full bank (DFB), the minimum paid-up capital requirement at the end of the transition period is Rs10 billion. But that's just one component: the entire process is long and tedious, with the timeline for commercial launch exceeding two and a half years (based on the electronic money institutions). During that time, the bank will have to set up all departments from compliance to dispute resolution and bear the payroll of at least 100 people while not earning a single rupee.

Basically, in order to get the commercial license and early customer acquisition, the bank would easily need $150-200m in funding, if not more. First, that requires big investors and growth stage capital which simply hasn't come to Pakistan yet and therefore is a big risk. This is not your typical marketplace startup where a great fundraiser can put up a $50m (which itself is a huge amount) round, and that would get the job done. You can't just play fast and loose with depositors' money as if it were investors.

Second, investors would need to see a potential for valuation step up at the time of initial public offering (as DFBs are required to list), something our stock exchange just can't offer. Existing banks are already trading below the price-to-book despite returning healthy profits. Imagine how they would value a loss-running company.

Now, of course, there are countless cases to be made against the SBP's picks, from Easypaisa's hefty losses to HugoSave's own credentials. Plus, none of the arguments about the use cases of sponsors like M&P and City School really justify the need for a banking license. It would have been far easier to actually partner with an existing fintech than try their hands at building a digital bank — when they have absolutely no experience in either tech or financial services at scale.

However, in our excitement and optimism, we kind of miss the bigger point: digital in itself won't make financial services more inclusive. The solutions and user experience of the new platforms will continue to be guided by the perceptions and myths of urban millennials and GenZ, who, over their expensive coffees, will deliberate on what the farmer from Rajanpur or the woman artisan from Tharparkar. Similarly, banks' incentive to lend to the government will not just disappear overnight, nor will the risk in lending to the underserved segments. Unfortunately, that's something the license will not and can not solve for.

Dawn 23-1-2023

GMO LICENCE IS ONLY HURTING PROCESSORS: AROUND 800,000 TONS OF IMPORTED SOYBEAN AND CANOLA DENIED CLEARANCE

LAHORE: Pakistan has been importing around two million tons of soybean since 2015 and one million tons of canola since 2002. Currently, around 800,000 tons of soybean and canola, imported in 12 ships, worth around $500 million are stuck at port as these are being denied clearance by the Ministry of Food and Agriculture over the demand of licence for genetically modified organism (GMO) grain imports, even though the same grain is being imported for 20+ years.

The impasse is causing huge losses to the poultry, cooking oil, solvent extraction and dairy sectors, and contributing to the further worsening of food inflation. These industries employ millions of people and collectively form the largest tax contributing sectors of the economy after textile.

The halted cargoes have sparked a debate on GMO and non-GMO feed. It is the differentiator between cultivation and processing.

GMOs intended for cultivation obviously require detailed risk assessments of the impact on agriculture and the environment. Industrial processing, on the other hand, is a much simpler application, and basically requires human and animal health risk assessments, which do not need to be repeated for each country/ environment.

Importing countries normally accept specific GMO traits, which have undergone thorough and extensive testing by credible institutions in the country of origin. Around 40 countries including China, EU members, Saudi Arabia, Malaysia, Turkey, Japan, etc are importing the same grains.

Pakistan has been cultivating GMO cotton since 2005 and cottonseed has been part of our food chain since then. In fact, we are the only country in the world which is cultivating GMOs and not allowing its import for processing. We have sufficient raw material in the country for poultry feed. But why would any business avoid using locally available raw material and opt for imports, which require more financing and higher exposure to market volatility? Whatever raw material is available is being utilised already in poultry as well as other feeds, for instance.

The fact is that corn-soybean is the most effective poultry feed formulation used worldwide.

There is another understanding that we were making poultry feed without soybean before 2015. That's not true. Pakistan's poultry feed processing landscape was never manufacturing the feed without soybean. We were importing soybean from India, albeit in smaller volumes. India has now become a net importer of soybean.

In fact, the industry's average Feed Conversion Ratio (FCR), which is the ratio between the feed given and the chicken weight, has now improved from around 2.5 to 1.5, implying an efficiency gain of up to 40%, which has been critical in keeping poultry prices at affordable levels.

There was another speculation that the importers have switched to non-GMO sources since the vessels were not available. Non-GMO soybean is not available in commercial volumes. And such mills, which had stashes of non-GMO soybean, have already exhausted their inventory. No non-GMO soybean cargo has been purchased since the crisis.

Sellers were able to ship non-GMO canola for three contracts due to an unusually large canola crop in Australia. Interestingly, one of these cargoes from Ukraine was declared as GMO after testing due to the lack of availability of proper standards.

The import permit for soybean mentioned no requirement for a GMO licence prior to 2018. After the import permit was revised in 2018, feed processors applied for a licence to import these grains for processing, which is called Food, Feed or Processing (FFP) with the Ministry of Climate Change.

The applications usually included detailed risk assessment reports from the exporting as well as importing countries, and other prescribed information.

The National Biosafety Committee (NBC) formed a sub-committee in August 2020 to evaluate the applications as Pakistan Biosafety Rules 2005 lacked a proper process for FFP applications.

The sub-committee's recommendations were approved in the 29th meeting of Technical Advisory Committee (TAC) on February 2, 2022, and are now awaiting final approval in the upcoming meeting of NBC.

There is still no legal framework for a processing licence. The licence procedure or even the application forms for FFP have not been prescribed.

This trickle-down effect is faced by the end-user eventually. Processors will bear losses in the future but the continuing rising prices of chicken are worrisome. And it is only going to increase, if the issue is not addressed on an emergency basis.

TR 23-1-2023

SBP ISSUES QUOTA-BASED SUGAR EXPORT MECHANISM

KARACHI: The State Bank of Pakistan (SBP), following instructions from the government, has issued a mechanism for the export of sugar and advised banks to process export cases in accordance with the allotted quota. On January 18, 2023, the Ministry of Commerce allowed the export of 250,000 metric tonnes of sugar by sugar mills. In a circular released late on Friday, the SBP directed banks to process the cases regarding the allocation of sugar export quotas for the provinces of Punjab and Khyber Pakhtunkhwa.

"The authorised dealers (ADs) will forward the requests of sugar mills through their respective Group Heads to the Director, Foreign Exchange Operations Department (FEOD), SBP-Banking Services Corporation (BSC), Head Office, Karachi for approval quoting the reference of this circular letter along with the copies of the banks (duly attested by the bank)," the SBP said in a circular. As per the mechanism, mills must provide a sugar export contract and clearance certificate issued by the concerned cane commissioner to the effect that the concerned sugar mill has cleared outstanding dues of the farmers for sugarcane crop up to 2021-22. Printout of the electronically generated financial instrument for export through Pakistan Single Window (PSW) will also be needed, it said. The FEOD will allocate sugar export quota to the sugar mills on a first come first served basis, based on the date/time of the case received through the SBP regulatory approval system.

The export by the sugar mill will strictly be made through the bank that has submitted the request for quota allocation, according to the circular. There will be no subsidy by the federal or provincial governments for export under the above scheme, the SBP said and added that banks will ensure to obtain irrevocable letters of credit (LC) from the buyer. In addition, the export proceeds will be realised within 60 days of the opening of LC. While calculating a period of 60 days, both days of LC opening and realisation will be included.

The bank will ensure that export by a sugar mill does not exceed the quota allocated to it and there will be no provision of surrendering, transferring, or amending the quota once allocated by FEOD, the SBP said. The quota for sugar export for the province of Sindh will be allocated by the cane commissioner of the province, it added.

TN 22-1-2023

PRESIDENT TAKES NOTICE OF INCREASING ONLINE BANK FRAUDS

President Dr Arif Alvi has taken serious notice of the rising trend of online banking frauds where fraudsters obtained contact details of banks' clients by impersonating as bank officials to get account and banking information and then using these details to swindle money out of clients' accounts.

The president directed the Banking Mohtasib of Pakistan to take serious notice of this worrisome trend and take substantive, meaningful, and effective steps by placing appropriate checks and balances, and foolproof security systems by using technology capable of differentiating between the genuine and fraudulent transaction attempts to curb this menace on an urgent basis, President Secretariat Press Wing said in a press release on Saturday.

The president expressed his concern over the news reports about an online bank fraud wherein renowned novelist and playwright, Mirza Athar Baig, was deprived of Rs 1.1 million from his bank account by an online fraudster.

The president's secretariat, under the direction of the president, has asked Mirza Athar Baig to lodge a complaint and formally raise the matter with the BMP to get relief if the bank was unable to resolve his issue and compensate him within the stipulated time period.

The president said that it was upsetting that fraudulent activities and practices were on the rise in the banking sector despite the fact that hundreds of such fraud cases had been decided by him through the Banking Mohtasib of Pakistan (BMP) and relief had been provided to the affectees of the online frauds. He also stressed upon the need of bringing about structured and systematic improvements in online banking mechanisms by immediately identifying the fraudulent persons and taking strong exemplary punitive actions against them.

The president emphasized that all the banks should collectively launch an awareness campaign through all forms of media, conventional and digital, to educate bank customers about the secure use of online banking platforms, besides ensuring compliance with the State Bank of Pakistan's directions and prescribed SOPs regarding the use of online banking facilities with ease, comfort, and security.

Times 22-1-2023

KP'S BUSINESS COMMUNITY HAILS PASSAGE OF SBP (AMENDMENT) BILL 2021

PESHAWAR: Business community in Khyber Pakhtunkhwa widely welcomed the passage of State Bank of Pakistan (Amendment) Bill 2021 with majority of vote, terming it as milestone achievement and important development for the smaller federating units.

The praise worthy remarks came during a joint meeting of traders and industrialists that was chaired by president of Sarhad Chamber of Commerce and Industry (SCCI) Muhammad Ishaq, here at the chamber's house. Eminent industrialists and traders, representatives of various stakeholders and sectors, exporters and importers were present during the meeting.

The legislation would rectify unjustified and inequitable credit lending that has been the long-standing demand of the smaller provinces, according to the participants of the meeting. Before passage of the bill the loan disbursement by commercial banks against deposits from KP and Balochistan was 1.35 percent only, which after the passage of bill will increase to about 5 percent. This will help in more trade and industrialisation in both the provinces, speakers said. Muhammad Ishaq lauded the efforts of leading businessmen of Khyber Pakhtunkhwa Senator Mohsin Aziz in the Senate, who presented the SBP (Amendment) Bill 2021 in the Senate.

FRANKFURT 'STIRS' UP EURO CLEARING BATTLE WITH LONDON

Frankfurt expands derivatives clearing on Monday in an early test of how well European Union ambitions to lure trillions of euros of business from London could work in practice.
With Britain now outside the EU due to Brexit, Brussels wants to reduce heavy EU reliance on London for clearing euro-denominated derivatives worth trillions of euros, triggering a skirmish between the world's biggest exchanges.

Wrestling business from London will be a long haul, though, given the bulk of clearing in heavily used contracts is based in the UK capital, banks have refused to shift business voluntarily, and the EU has yet to say exactly much volume it wants to see moving, industry officials say.

Clearing, which ensures a trade is completed even if one side of the deal goes bust, is key to amassing the critical liquidity financial centres need to attract investors.

Last month Brussels proposed a draft law that would force banks in the bloc to have an account with an EU-based clearing house to clear a yet-to-be-determined minimum amount of three types of euro derivatives contracts which are widely used by companies. One of these - euro short-term interest rates contracts or STIR - are mainly cleared outside the EU, dominated by ICE in London to such an extent that EU securities watchdog ESMA described it as monopolist.

Deutsche Boerse’s Eurex derivatives arm in Frankfurt, already strong in contracts covering the longer end of the euro yield curve, will offer trading and clearing in a new three-month futures contract from Jan. 23 referencing the estr interest rate compiled by the European Central Bank.

“Expanding the STIR segment underlines our commitment to be the home of the euro yield curve and delivering maximum margin and capital efficiencies to the market,” Eurex said.

US derivatives exchange CME already launched its own three-month estr futures contract last October, which banks in the EU can also trade, adding to the challenge faced by Eurex.

ICE’s euro STIRs volume is, however, in its huge euribor contract, which traded 365 million lots in 2022, a 66% rise on the prior year as the European Central Bank hiked interest rates sending companies rushing to hedge themselves. “We are continuously evaluating opportunities to make further adjustments in our STIR offering including our listed euribor futures and options,” Eurex said.

Patrick Young, a former futures trader in London and founder of Exchange Invest newsletter, said Eurex is obliged to try everything to end London’s longstanding dominance in short-term interest rate futures trading given the EU policy efforts.

It is a tall order, though. “Margin offsets remain the key problem as ICE has a broader pool of competing asset classes to offset than mono-currency Eurex,” Young said.

‘TAKE YEARS’

ESMA will calibrate how much of each of the three specified derivatives contracts banks must clear in the bloc.

The other two are euro credit default swaps (CDS), also cleared by ICE in London and Chicago, and euro interest rate swaps (IRS), dominated by London Stock Exchange Group’s LCH in London.

Shifting clearing can be risky for customers as it involves closing contracts at one clearing house and opening matching ones in another, exposing them to disruptive market moves.

Brussels is allowing EU banks to continue clearing in London until June 2025, though industry officials say an extension is inevitable given the time it could take for enough clearing to shift given banks’ hostility.—Reuters

R 22-1-2023