FTfm

Post-trade services come into their own

Bill Butcher

Overview

The new regulatory focus is prompting more widespread use of clearing, says **Jeremy Grant**

In the traumatic weeks surrounding the collapse of Lehman Brothers, news headlines were dominated by the failure of one of the world's best known investment banks and the collateral damage inflicted on the global financial sector as the default rippled through the system.

Yet missing from the narrative was the work of a group of players in the financial services industry who make it their business to deal with the possibility of such events – albeit not, up to that point, on such a scale. Clearing houses and settlement systems set to work to establish who owed what to whom, and how positions could be safely unwound to avoid the damage spreading.

These post-trade services businesses have for years functioned below the radar. A description of what they do makes for dry reading: a clearing house acts as buyer for every seller and seller for every buyer in a transaction, helping to virtually eliminate counterparty risk – that is, the risk that a party to a transaction ends up defaulting. Settlement is the process by which a security in a transaction is exchanged for cash, irrevocably.

Even the European Commission, on its website, recognises the unglamorous nature of the business, saying: "[Financial markets] infrastructure has often been compared to the plumbing in the building . . . vital but unglamorous and forgotten until something goes wrong".

When something did go wrong – badly wrong – in September last year, the business of clearing and settlement quietly worked through billions of dollars worth of exposures between Lehman and its various counterparties.

Don Donahue, chairman and chief executive of The Depository Trust & Clearing Corporation, the US clearer and settlement group, summed up the result in the deadpan way that is typical of many in the sector, saying: "The industry's infrastructure did not buckle in the face of the storm. There were no headlines in the press about settlement failures. There were no bulletins about system collapses in the face of torrential volumes . . . no reports about risk management breakdowns or under-collateralised clearing obligations."

Notably, neither DTCC nor LCH.Clearnet, the London-based clearer that is Europe's largest independent clearing house, needed to draw on any of the default funds that typically sit with a clearing house as the ultimate resort in case of catastrophic default.

The way the post-trade business worked through the Lehman crisis reinforced to regulators what they had started to realise: clearing and settlement infrastructures would be crucial to avoiding the next big financial blow-up and containing systemic risk.

Don Donahue
chairman, DTCC

In August, a group of financial experts led by former New York Federal Reserve bank chairman Gerald Corrigan produced a report for the US Treasury and the Financial Stability Forum recommending reforms to the financial system in response to the credit crisis. Among the recommendations by The Counterparty Risk Management Policy Group were strengthening safeguards around the bilaterally-negotiated, uncleared, over-the-counter derivatives markets that would see OTC credit default swaps moved into a centralised, counterparty clearing arrangement (CCP) – or clearing house.

Roger Liddell, chief executive of LCH.Clearnet, says: "People have become alerted to the dangers of the bilateral risks they face."

Exchanges, sensing a new business opportunity, have seized apon the new regulatory focus on ensuring transparency and market certainty through a more widespread use of CCPs.

Four groups are busy preparing clearing solutions for the OTC credit markets: CME Group and Citadel, a Chicago hedge fund; NYSE Euronext in conjunction with LCH.Clearnet; IntercontinentalExchange, the futures exchange, with The Clearing Corporation; and Eurex Clearing, the clearing arm of Deutsche Börse.

John Trundle, head of risk at Euroclear, says the trend, even in markets beyond OTC products, is clear. "I think where there are very large markets that have not been organised through well organised central reliable infrastructures there will be strong pressure to get those markets organised in a standardised way.

"There will be emphasis on commoditisation of transactions and on harmonisation of the rules and doing everything in a predictable, standardised, robust way. 'Boring' is the new exciting at the moment," he says.

Clearing initiatives have proliferated in recent months. Nasdaq OMX, the US-based exchange group, has announced plans to set up a US equities clearing operation that would compete with DTCC; invested in a new OTC derivatives clearing business for interest rate swaps; and recently acquired Nord Pool Clearing, a Norwegian commodity and

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Credit derivatives drive hits a wall

OTC Clearing

Proposals to confront fears over systemic risk have so far proved unsatisfactory, says **Paul J Davies**

In early April last year a group of leading investment banks blew the dust off their ownership of a near forgotten company with no chief executive, just 40 staff and Chicago offices that were dominated by unoccupied cubicles.

Their plan for this atrophied asset was to confront directly regulators' fears over the systemic risks posed by the huge over-the-counter credit derivatives market – fears heightened weeks earlier by the failure of Bear Stearns, which had been a huge player in the field.

The Clearing Corporation, jointly owned by 11 leading banks including Deutsche Bank, Credit Suisse, Goldman Sachs and some other trading platform providers, became the focal point for the first efforts to create some form of clearing house in the market.

A clearing house provides the certainty that if a big player fails, everyone will know immediately what their exposure to that party is and there will be a central deposit of collateral that should cover money owed on outstanding contracts. For individual banks, a clearing house gives them one main counterparty, rather than the hundreds of different counterparties they have in an OTC market.

The credit derivatives industry has grown and evolved as a purely bilateral market, without any central clearing mechanism and has fiercely resisted suggestions that banks should move their private or OTC trading activity on to regulated exchanges.

But if the dealers were hoping to stitch up the issue neatly, they would have soon been disappointed as other groups rushed to get in on the act.

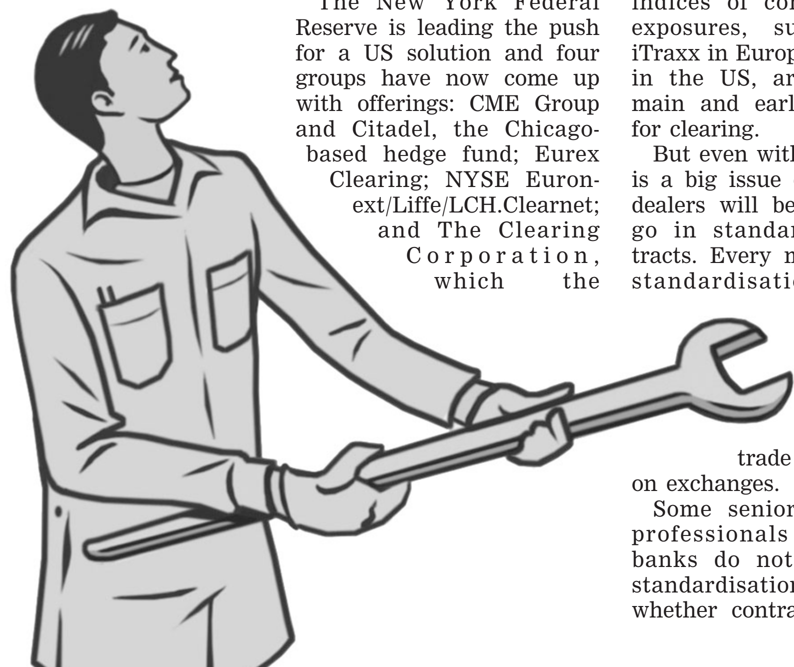
The New York Federal Reserve is leading the push for a US solution and four groups have now come up with offerings: CME Group and Citadel, the Chicago-based hedge fund; Eurex Clearing; NYSE Euronext/Liffe/LCH.Clearnet; and The Clearing Corporation, which the banks sold a stake in to IntercontinentalExchange late last year.

The pressure to get something up and running only increased following the collapse of Lehman Brothers, which the CDS market nonetheless dealt with in an orderly fashion after having been told to prepare for such an event in the wake of Bear Stearns.

However, the last time the NY Fed met the hopefuls, their proposals were far from satisfactory and work is still ongoing to settle many tricky issues such as who will be able to join, what the costs of use will be and what kinds of contracts will be included.

The simplest, most liquid contracts based on popular indices of corporate debt exposures, such as the iTraxx in Europe or the CDX in the US, are the likely main and early candidates for clearing.

But even with these, there is a big issue over how far dealers will be prepared to go in standardising contracts. Every move towards standardisation removes some potential profitability and makes it easier to trade the contracts on exchanges.



Some senior derivatives professionals insist that banks do not care about standardisation – or even whether contracts do eventually move on to exchanges.

"We are happy to trade equities and futures contracts, we do good business there and make money – so where's the issue?" says one.

As the trading arms of investment banks this year increasingly look to safe, high-volume business conducted on behalf of clients rather than taking big positions themselves, such an attitude might become much more broadly discernible.

There remains great uncertainty over which or how many of the four US proposals will get off the ground, but the Depository Trust & Clearing Corporation, the US clearer and settlement system, this month said it would support all those proposed solutions. The DTCC is central to the effort since its "trade information warehouse" is the central registry for confirmed CDS trades.

Within the industry, the idea was always that the US solution would be the de facto global solution. However, the European Commission threw a spanner in the works late last year when it called for Europe to have its own clearing house for the CDS markets.

Officials are concerned that European regulators might be unable to touch a US clearing house that ran into difficulties, given that the clearing house would be subject to US jurisdiction.

Brussels demanded a tight deadline of the end of December for concrete proposals and in order that a clear timetable could be drawn up to fit in with European political deadlines.

However, the efforts failed to achieve a commitment from a sufficient number of dealers to get a European clearing solution off the ground by June – and the effort has hit a roadblock.

Jargon buster

Back office: the part of a firm that is responsible for post-trade activities.

Central counterparty (CCP), or clearing house: an entity that is the buyer to every seller and the seller to every buyer of a specified set of contracts or obligations.

Central securities depository (CSD): an infrastructure that holds or controls holding of financial instruments in paper or electronic form belonging to all, or a large proportion of the investors in a particular securities market. The CSD effects the centralised transfer of ownership of such securities by entries on its books or records.

Clearing member: a member of a clearing house.

Code of conduct: agreement brokered by the European Commission and agreed in 2006 by the chief executives of European securities trading and post-trading companies with the aim of offering market participants the freedom to choose their preferred provider of clearing services.

Confirmation: the procedure for verifying trade details with a counterparty.

Counterparty: the opposite party in a financial transaction.

Custodian: the party that safekeeps and administers assets on behalf of the owner.

Derivative: a financial contract, the value of which depends on the value of one or more reference assets, rates or indices.

Front office: a firm's trading unit and other areas that are responsible for developing and managing relationships with counterparties.

International central securities depository (ICSD): an entity that settles trades in international securities and cross-border transactions in various domestic securities.

Interoperability: where one infrastructure service provider – typically a clearing house – creates a business relationship with another. It is the opposite of a "silo" structure, where a clearer may be owned by an exchange.

Netting: an agreed offsetting of positions or obligations by trading partners or participants. Netting reduces a large number of gross positions or obligations to a smaller number and can sharply reduce settlement volumes.

Over the counter: market outside an organised exchange in which transactions are conducted through a telephone or computer network connecting the market participants.

Settlement: the completion of a transaction whereby the seller transfers securities to the buyer and the buyer transfers money to the seller.

Straight-through processing (STP): the capture of trade details directly from front-end trading systems and complete automated processing of confirmations and settlement instructions without the need for manual intervention.

Adapted from "Plumbers and Visionaries: Securities Settlement and Europe's Financial Market", Peter Norman, John Wiley & Sons, Ltd (2007)

Post-trade services come into their own

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power clearer that will soon clear for the UK's first electricity exchange.

Eurex will in the second quarter launch a CCP service for securities lending, in conjunction with Clearstream, Deutsche Börse's settlement arm.

The same trend is evident in the energy markets. Sara Stahl, business development manager at the European Energy Exchange, says: "In the carbon market, credit is certainly an issue as many counterparties are new to each other and as such are trying to minimise counterparty risk."

LCH.Clearnet and DTCC are busy expanding their business, with the London clearer set in the second quarter to launch Synapse, the world's first multi-asset derivatives clearing platform, and the only one capable of supporting all exchange traded and most OTC contracts.

At the same time, there is an increased focus on risk management at broker-dealers and custodians. Lee Waite, global head of Citi's global custody and clearing intermediaries business, says: "People are very on top of their game, monitoring their systems and making sure they are right up to snuff and if they are not there is a very quick escalation in the urgency of dealing with the issue."

Yet the push by exchanges into clearing has met with some suspicion by dealers at the banks, and at inter-dealer brokers that have long specialised in tailor-made OTC contracts which, they contend, do not lend themselves to clearing. That is likely to lead to an intense debate.

The inter-dealer brokers are also concerned that the exchanges' ultimate ambition is to migrate as many OTC contracts on-exchange for trading as well. The Wholesale Markets Brokers' Association, which represents the interests of the inter-dealer brokers such as Icap, Tullett-Prebon, GFI and BGC, says that while its industry has to accept that more clearing is "inevitable", more tailored products will not be cleared through exchanges.

The focus on clearing and settlement comes as reforms have been underway in Europe to harmonise cross-border settlement and spur competition between clearers, and increase the opportunities for market participants to choose where their trades are cleared.

Such initiatives, being led by Brussels and the European Central Bank, are taking place as part of an effort to reduce post-trade costs in the region, levelling the playing field with the US, where post-trade services are far less fragmented. In Europe, for example, there are still 17 nationally based Central Securities Depositories handling settlement, while in the US this is handled by the DTCC.

Hugh Cumberland, strategic business development manager at BT Global Services, says: "The world has changed, and one would imagine regulators need to look at things through fresh spectacles.

"The priorities would seem to be better global regulation and more centralisation of clearing functions along business lines."

Humble OCC emerges from shadows

Options

The largest equity derivatives clearing organisation has embarked on a string of deals in recent months, says **Hal Weitzman**

Wayne Luthringshausen is keen to point out that he's no John Thain.

"Look at this office!" jokes the chairman and chief executive of the Options Clearing Corporation as he indicates his modest workspace in the organisation's Chicago headquarters. "No windows! No $35,000 toilet! And these chairs are 20 years old!"

The lack of opulence is fitting. The OCC may be the largest equity derivatives clearing organisation in the world but it is structured as a non-profit-making utility, run by clearing member firms and options exchanges. "Our strategy is simple," says Mr Luthringshausen. "We provide the greatest, most reliable service in the world and we do it at a low price."

The OCC was formed in 1975, when the US government essentially nationalised the Chicago Board Options Exchange's clearing house to serve as a central clearer for the US options market, which remains its primary role. Mr Luthringshausen, who had previously been one of the main players in the formation of the CBOE and its clearing house, has been in charge of the organisation since the start.

As a clearing veteran with more than three decades of experience, his observations are often big-picture and conceptual. Clearing, for example, is like refuse collection, he says. "If you run a garbage company, nobody wants to read your newsletter or see your monthly reports. The only time they care is when you don't pick up the garbage. Clearing's like that. As long as we're doing our jobs and everything's working, nobody cares about where we are and what we're doing."

One consequence of the financial crisis is that clearing is suddenly being given more attention, particularly in terms of regulators' desire to establish central clearing for over-the-counter credit derivatives. Although the OCC is not currently involved in any of the initiatives that have been proposed to clear credit default swaps, Mr Luthringshausen says the organisation participated in the discussions chaired by Tim Geithner, the new US Treasury secretary, in his former role as president of the New York Federal Reserve.

"We were the only honest brokers at the table over this CDS clearing stuff," says Mr Luthringshausen. "We had some exchanges ask us about being a partner on that. But we saw as one of the requirements that we had to be ready by December 31 2008. Everybody else said: 'We can be ready'. We said: 'No, we can't do it. It would be dishonest of us to say we can.'"

Since the main US players are yet to launch their CDS clearing solutions, some might argue that the OCC was too honest for its own good. However, Mr Luthringshausen says the organisation is "still talking to people about it" and could get involved in the future.

In the meantime, OCC has embarked on a string of clearing deals in recent months. It has signed agreements with both NYSE-Liffe and ELX, a consortium of 12 banks and market-makers, to perform clearing for their respective attempts to break the dominance of the CME Group – the world's largest futures exchange – in the US listed futures market.

It has also struck a deal with Quadriserve, a new exchange for securities lending.

While the first two ventures – which could greatly expand OCC's role as a futures clearer – have attracted more interest, Mr Luthringshausen is far from convinced they will be able to break the CME's 98 per cent market share. "Can the model really work in an environment where there's no fungibility?" he says. "We can make the clearing successful but we can't ensure there'll be volume."

He is less doubtful about the Quadriserve deal. "We're taking this out of the backroom and bringing it into the light of day," he says. "We're going to margin this, collateralise it, give it a pricing mechanism and a clearing system. If it catches on, we're going to increase the size of this market. It could be bigger for us than futures."

Michael Cahill, OCC's president and chief operating officer, says the new deals reflect that the utility model still has great value, in spite of the move towards more "vertical" clearing in the futures world, where InterContinental Exchange last year withdrew from LCH.Clearnet and created ICE Clear Europe, its own clearing house.

He says the big banks that back the ELX venture prefer OCC's structure. "Goldman Sachs, Merril Lynch, Bank of America – they want a utility model," says Mr Cahill. "It's the people who run the CME and the ICE – they're the ones who want the vertical model. As a customer, I would want the lower fees at OCC." Any future deals will be judged on whether they are a good fit with OCC's culture, says Mr Cahill.

Mr Luthringshausen is clear that above all else, the OCC must stick to its knitting.

"We've got an opportunity to expand our vision now," he says. "We got that opportunity because we just kept doing the right thing."

Wayne Luthringshausen: 'We got that opportunity because we just kept doing the right thing'

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Europe’s post-trade infrastructure poised at the crossroads

Reform Debate

A large group of clearers will spur competition, some say, while others argue consolidation is safer, writes Jeremy Grant

The past year has seen reforms sweep across Europe in an attempt to streamline its fragmented post-trade infrastructure, the result of an effort that started before the adoption of the euro.

A year ago, lack of competition at the trading level was dealt with by Mifid, the Brussels directive that has spurred competition between trading venues, pitting established exchanges against start-ups such as Chi-X, BATS and Nasdaq OMX Europe.

But post-trade fees, which are charged by clearing houses and settlement system providers and are important elements of the cost of trading, have been slower to fall amid lack of full competition at the clearing level.

The European Commission in 2006 brokered a “Code of Conduct” with the securities industry, including exchanges and clearers, designed to spur competition to create a market structure that would allow participants to choose where their transactions can be cleared.

The idea was that clearers would become “interoperable” with each other. While there are more than 80 requests for “interoperability” outstanding between clearers and exchanges with their own clearing operations, progress has been slow because of national regulatory barriers and a fear among some exchange-owned clearers that they stand to lose revenue.

In the settlement area, The European Central Bank has launched Target2-Securities (T2S), which envisages the creation of a single platform for cross-border and domestic securities settlement against central bank money, by 2013.

Clearstream has launched “Link Up Markets”, a joint venture by eight Central Securities Depositories that establishes a common infrastructure linking each national CSD.

Finally, Euroclear last month launched ESES, a securities settlement platform that for the first time allows market participants in Belgium, France and the Netherlands to process fixed income and equity transactions using the same platforms – and marking a big step by the private sector in removing some of the so-called Giovannini Barriers to efficient cross-border settlement identified by a special EC-commissioned working group in 2001. Euroclear is also working on a “single platform” for securities settlement by 2011.

Fast forward to the financial crisis at the end of last year, and the multi-faceted effort to streamline and harmonise Europe’s post-trade landscape is at a crossroads.

On the one hand, the crisis has underscored the importance of post-trade infrastructures, as a declaration by Ecofin, the EU finance ministers council, made clear in early December: “Building a safer, more stable and efficient global financial system therefore requires to step up the EU ambitions for post-trade infrastructures with emphasis on safety and soundness”.

But at the same time this increased focus on risk as a result of the crisis has led to a debate between those who believe that a proliferation of clearing central counterparties (CCPs) is a good thing for competition, and those who argue that the region would be better off with fewer CCPs for “safety and soundness” reasons and that far-reaching interoperability is not the answer.

Miranda Mizen, analyst at Tabb Group, a consultancy, says in a report out last month: “A year ago if you asked any broker what their top considerations for clearing were, they would have said cost and risk management.

Jan Bart de Boer: cautions against too much consolidation

“Today, the top three concerns are risk, risk and risk, as they balance new trading opportunities with greater post-trade concerns.

“Europe badly needs competitive clearing to reduce costs and increase efficiency but . . . there are currently eight CCPs, and there potentially will be more, many of which want to compete in the same space, and this is not going to be viable,” she says.

Ms Mizen argues that a smaller group of competitors “will bring more credible ownership, economies of scale, innovation and the ability to diversify”. She says three pan-European CCPs would be best.

Supporters of this view generally like the planned combination of The Depository Trust & Clearing Corporation, the vast US post-trade service provider, and LCH.Clearnet, Europe’s largest independent clearer, which clears for the London Stock Exchange, Euronext, the London Metal Exchange, Liffe and others. This would create a post-trade behemoth in Europe and one straddling the Atlantic, competing with Deutsche Börse and its Eurex Clearing and Clearstream settlement arm, and – in settlement – with Euroclear, Europe’s largest settlement provider.

However, Jan Bart de Boer, chairman of EMCF, a clearer set up by the formerly privately held Fortis bank, now held by the newly constituted Fortis and Nasdaq OMX, cautions against too much consolidation. “There are voices who are now saying we have financial turmoil and therefore we need to have one CCP in Europe because we have less risk. Our position is you need to have multiple CCPs with individual boxes of risk, instead of putting all the risks in one box and calling it ‘Pandora’,” he says.

Commenting on the closure last week of Nasdaq’s 22 per cent stake in EMCF, Mr de Boer said: “EMCF has proven that in post-trading it is competition, not consolidation, that delivers better and cheaper services.”

Some argue that without progress on interoperability, competition will only be possible up to a point. Only in Switzerland and Britain is there any evidence of interoperability. The LSE’s recent decision to allow SIS X-Clear, the Swiss clearer, to compete with LCH.Clearnet in the clearing of LSE equities trades, has only just started and time will tell how it will work.

Marco Strimer, X-Clear chief executive, says competition will be “stilted” until others commit to interoperability. “The code does have a future,” he says “which we feel will be seen in the near and medium term. Clients want a choice of clearer in order to benefit from cross netting, collateral management and reduced settlements and reconciliation of stock positions at multiple venues.”

Yet the emergence of EMCF and Euro CCP, DTCC’s European equities clearer, both of which are clearing for the handful of new “multilateral trading platforms” such as Chi-X and Turquoise, has brought clearing costs down even as clearing choice remains limited.

Efforts to streamline settlement have been proceeding with their own complications. The T2S initiative aims to link the various nationally based central securities depositories together by 2013, while Euroclear’s single platform is due in 2011.

Last month’s Euroclear launch of ESES, the settlement platform that for the first time allows market participants in three EU markets – Belgium, France and the Netherlands – to process all fixed income and equity transactions using the same platform – removes some of the complexity, risk and costs identified by the Giovannini Group.

Yet there is unease among some market participants over whether both T2S and the single platform are needed, and what this means if DTCC manages to set up a significant settlement beachhead in Europe. Hugh Cumberland, strategic business development manager at BT Global Services, says: “A lot of people are asking ‘do we need both?’ Especially in the current economic climate, do global custodians and broker-dealers want to pay to integrate the two? That’s a bit of a conundrum.”

Emerging markets move to establish solutions

The increased focus on clearing and settlement is not limited to the obvious developed markets of western Europe and the US. Less developed – or less immediately obvious – markets are also moving with the tide.

The Bond Exchange of South Africa (BESA) is set, subject to local regulatory approval, to introduce in the second quarter clearing of fixed income derivatives, repo bonds and cash bonds through BondClear, a clearing house owned by the exchange and in which Nasdaq OMX has a 20 per cent stake.

South Africa is the sixth most liquid government bond market according to the Bank for International Settlements, while the World Federation of Exchanges ranks Besa the fourth largest exchange-trade bond market.

Besa operates a hybrid exchange model where trades are done over the counter – bilaterally negotiated – and then matched on exchange.

Garth Gruebel, Besa chief executive, says the lack of a clearing facility has been “an impediment” to getting a fixed income derivatives market going in South Africa because the long-dated nature of such futures contracts means that bilateral credit lines are tied up. “If you can put it through a CCP [central counterparty] and you can manage your exposures on a daily basis that creates the opportunity for greater trading of a derivatives instrument,” he says.

BondClear says it will offer “a comprehensive clearing solution including matching, CCP services, risk management and settlement with risk management being underpinned by Nasdaq OMX’s balance sheet which acts as ultimate acceptor of risk”.

On the settlement side Central Depository Romania, the eastern European country’s settlement system, last month launched a new service providing direct access to eurobonds traded on international markets for Romanian investors, through a new direct link with Clearstream Banking Luxembourg, a unit of Deutsche Börse’s Clearstream settlement system.

A little oasis of calm for currencies

Forex

Progress has been made eliminating settlement risk, but concerns remain, says Steve Johnson

In the depths of the mid-1970s recession, a swathe of US banks was left out of pocket when Herstatt Bank, a privately owned German operation, was put into liquidation by German regulators.

The Americans had handed over dollars to Herstatt earlier that day as one leg of routine foreign exchange transactions; they fully expected deutschemarks in return a matter of hours later.

The actions of the German regulators rudely interrupted this process. The deutschemarks were never handed over and the phrase “Herstatt risk” became synonymous with settlement risk in the FX community, giving the Cologne-based bank far greater notoriety in death than it ever achieved in life.

The later collapses of Bank of Credit and Commerce International in 1991 and Barings in 1995 led to similar losses, but despite the turmoil currently roiling the banking industry – and ever-rising turnover in the FX market, some $3,200bn (£2,268bn, €2,424bn) a day according to the Bank for International Settlements – there have been no reports of similar mishaps this time.

This oasis of financial competence is largely attributed to the activities of CLS Bank, established by a consortium of global financial institutions in 2002.

CLS, which now settles 55 per cent of all FX trades, operates a payment netting system that virtually eliminates settlement risk by, in effect, acting as a trusted third party between the counterparties.

FX settlement risk particularly worries central bankers because the sums involved are large enough to potentially create systemic risk in the global banking system. The success of CLS has been such that some industry figures believe the problems surrounding clearing and settlement in the FX world have now largely been solved, although others believe there is still work to do.

The BIS said last year that, while significant progress had been made in eliminating settlement risk through the development of CLS, it was still concerned about the 45 per cent of FX transactions settled elsewhere.

The concern is shared in the very highest corridors of power.

Tim Geithner, the new US Treasury secretary, said last year in his role as chairman of the BIS Committee on Payment and Settlement Systems: “The financial services industry has made significant progress in dealing with foreign exchange settlement risk.

“However, more can and should be done to tackle remaining exposures and to guard against the risk of reversing the progress that has already been achieved.”

Bill Boss
global head of FX at UBS

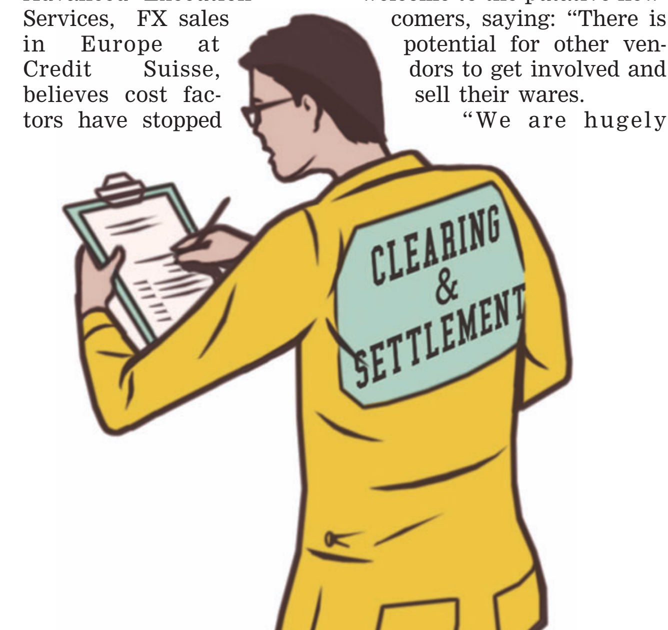
Bill Boss, global head of FX and money market operations at UBS, one of the banks that jointly own CLS, argues that part of the solution may simply be to expand the range of services CLS provides.

He suggests CLS could offer same-day settlement of trades such as dollar/yen, which is problematic due to the time difference between the US and Japan, expanding its current roster of 17 currencies and endeavouring to sign up more members.

Current daily turnover on the Forex market

“Getting a lot of customers on CLS is a good thing. Getting the remaining currencies on is a good thing,” he says. “When a trade or a currency pair or counterparty are not on CLS, that is when the fun begins. The industry does not have many ways around it.”

Jonathan Wykes, head of Advanced Execution Services, FX sales in Europe at Credit Suisse, believes cost factors have stopped CLS from increasing its penetration further still, particularly at a time when many participants are having to slice trades up in order to execute at the best price.



“The number of [deal] tickets is rising as people split their trades. It’s a very fragmented market, maybe you can do €10m at the best offer price, so do €10m times 10 venues. And with higher volatility, some market makers are in the market in smaller sizes. Liquidity has thinned out and spreads have widened.”

Greater take-up of bulking and netting arrangements before feeding trades into CLS could reduce charges, Mr Wykes argues, but this practice is currently frowned upon.

“A lot of people want to put their trades through CLS because it reduces their settlement risk and ultimately some of their credit risk as well, but the clients want to reduce the total cost of trading,” he says.

Most of AES’ trades do go through CLS but some go elsewhere, typically with a credit support annex or similar arrangement in place to reduce settlement risk.

Other operators may help fill gaps in the industry. LCH.Clearnet, Europe’s largest independent clearer, is working on a plan to start clearing FX trades.

Roger Liddell, chief executive, told the FT in October: “A lot of the risk is taken out by CLS but there are firms that are looking again at FX to see whether it makes sense to have a clearing offering as well. I think it’s distinctly possible that FX will have clearing arrangements.”

Icap, the inter-dealer broker, also has plans to expand into over-the-counter post-trade services, potentially including FX. Both Icap and LCH.Clearnet declined to comment for this article.

Mr Boss offered a qualified welcome to the putative newcomers, saying: “There is potential for other vendors to get involved and sell their wares.

CLS now settles 55 per cent of all FX trades — Daniel Lynch

“We are hugely supportive of CLS but there is always room for a smaller, more nimble vendor to be involved.”

However, he warned the fragmentation of settlement and clearing activities could reduce efficiency. “CLS is all about multilateral netting, which is more efficient. When you start eroding that and putting trades here and there it erodes a little bit of value,” he warns.

“But it’s always good from a competition viewpoint to have other operators.”

In the interim, UBS has looked at the potential of establishing an escrow service to act as a trusted third party for its clients, says Mr Boss, although this initiative has been held back by issues around secrecy, fees and the legal structure, as well as technical details.

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Competition and challenges ahead

Pierre Francotte
COMMENT

One piece of comforting news amid the financial turmoil is the post-trading infrastructure in Europe did not collapse. On the contrary, it proved resilient, a point acknowledged by regulators.

Central securities depositories (CSDs) and central counterparties (CCPs) absorbed massive volume volatility. The infrastructures most directly involved in managing the impact of the Lehman failure, LCH.Clearnet and Euroclear, incurred no losses and unwound their positions in a way that avoided risk for themselves and disruption in the market.

Euroclear Bank and Clearstream continued to provide their customers every day with the intra-day credit necessary to settle cross-border trades smoothly and were able to obtain the liquidity they needed from the banks they use for this purpose.

With more than €280,000bn (£260,000bn, $371,000bn) worth of transactions settled annually just by Euroclear Bank, this was critical to avoid potentially serious financial market disruption. It proved possible in a market where banks were no longer prepared to give credit to other banks because the international central securities depositories (ICSDs) are "single purpose banks", providing credit to facilitate settlement and not for conventional banking activities.

It is anyone's guess how the payments and securities markets would have coped if the two ICSDs had not been banks providing this kind of short-term credit to oil settlement activity. The industry and regulators are probably happy they did not have to find out. Yet, vigilance must be maintained.

Resilience does not mean that the post-trading infrastructure is immune from the impact of the crisis. Settlement activity and asset values are substantially down, putting pressure on the revenues of CSDs. Large, diversified providers, such as Euroclear, are more resilient to such shocks, but all post-trade service providers will need to cut their costs. In Euroclear, for instance, the cost base is being reduced by about 15 per cent over the next three years.

What are the prospects ahead for the post-trading industry?

Clearing has become the focal point. Clearing fees represent the larger portion of banks' post-trading costs because they are applied to gross trades, unlike settlement fees which are generally charged on netted trades (netting typically reduces the number of trades by 95 per cent).

Historically, there has been much more competition in the settlement field than in clearing. This is changing fast with Mifid, the markets in financial instruments directive, and the emergence of new CCPs, such as EMCF and DTCC's EuroCCP. Competition has helped lower clearing fees and there is probably more to come. But it has led also to greater fragmentation, creating concern about risk.

Unsurprisingly, it is with clearing that there is the greatest question about the likely success of the code of conduct – brokered between the European Commission and the securities industry – to encourage open access. Today, there are few examples of CCPs agreeing to set up the arrangements needed to allow effective competition by other CCPs, or by CSDs other than the CSD of their home markets. Local market or legal constraints are often blamed for this. The next few months will tell how the Commission intends to act if there is no real progress.

The main settlement-related issues in the coming years will be how CSDs will be able to reduce infrastructure costs and support their clients' efforts to reduce risk, especially as regulation will be unavoidably tightened.

The challenge is greater than meets the eye for many CSDs. Their revenue base will be under pressure due to the crisis, Target2-Securities (T2S) – the project of the European central bank to streamline cross-border settlement – will take away much of their settlement activity, and new entrants may start competing, not unlike what is occurring in the clearing field.

Some CSDs will want to adjust their business model and develop new services, but the appetite of their users and shareholders to finance large investments will be limited. Initiatives like T2S for settlement and Euroclear's "Single Platform" for the full range of CSD services respond to user demand for pan-European reach at much lower cost. The new settlement and corporate action platform just launched by Euroclear for the three Euronext-zone markets is a harbinger of the future in Europe: effectively, a standardised, borderless CSD service, gradually covering all of Europe as if it were a single domestic market. Other markets will be added, with more than 75 per cent of Euroclear's Single Platform already built.

Offering a domestic service to local clients will be challenging for CSDs. The future landscape will be characterised by new forms of partnerships and probably further consolidation. Competition will be tougher from those international CSDs and custodian banks that offer a single entry point to access all European bond, equity and fund markets. The solution to Europe's post-trading woes will be earned the old fashioned way: by painstakingly harmonising market practices and consolidating technology and processes to eliminate inefficiencies.

Pierre Francotte is chief executive of Euroclear

Striving for a one-stop, straight through shop

Processing

Europe's two players are about to be joined in competition by a third from the US, writes **Sophia Grene**

In the back office of the funds industry, Utopia can be represented with three letters: STP. They stand for straight through processing, an ordering, creation and settlement system that would require no manual intervention after the initial keying in of the investor's order.

The European industry is not quite there yet.

"The predominant technology in fund markets is still the fax. Some people call that STP, because it is usually an electronic fax," says Kevin Lee, chief executive of Calastone, a UK-based funds transaction network.

In the US, where the market is much more closely integrated than in Europe, despite the best efforts of the European Commission and even many industry players, there is one fund clearing and settlement platform, run by DTCC, the Depository Trust & Clearing Corporation.

In Europe, there are two major platforms: Vestima+ and CFF (Central Facility for Funds) run by Clearstream, and FundSettle, run by Euroclear.

In the next few months, DTCC is planning to enter the market with its Fund/SERV facility, a second attempt on the fragmented and multilingual European industry that defeated it six years ago.

So, what is different this time around – different enough to warrant DTCC's renewed optimism?

For a start, the European fund industry has grown enormously, especially in its cross-border aspect. In the five years to September 2008, assets held in Ucits funds, the European cross-border vehicles, grew by 44.7 per cent to €5.18bn (£4.8bn, $6.9bn), even after disastrous outflows and falls in global markets in the past six months.

It is also now much closer to the goal of STP than when DTCC first tried to offer its services to funds.

Clearstream's Vestima+, which routes fund orders to transfer agents, now counts more than 44,000 funds on its platform in more than 30 countries. The success of this fund processing platform led Clearstream to launch the central funds facility, which automates the post-trade settlement process, 18 months ago.

> 'The investment fund world needs a centralised place for settlement'
>
> **Philippe Seyll Clearstream**

"We believe the investment fund world needs a centralised place for settlement," says Philippe Seyll, head of investment fund services at Clearstream.

Clearstream has used the experience and infrastructure it has in securities clearing to build an analogous system for investment funds. A year and a half after launch, and five years after work started on the project, the CFF now has 35,000 funds on it. This scale is important, says Mr Seyll. "Not only did we build the solution, the centralised place would be nothing without the liquidity."

Euroclear has also made great strides with the acceptance of its clearing and settlement platform FundSettle. Unlike the Clearstream philosophy that funds can be treated in this arena similarly to other securities, Euroclear's offering was designed with the differences very much in mind.

"We've been able to build a platform for funds with the specificities of investment funds in mind," said Ivan Nicora, director and head of investment funds product management at Euroclear. These include the complex relationship between the distributor and the fund promoter. "What is driving the economics of investment funds is the retrocession fees between fund manager and distributors. We can automate the processing of the commission that is at the centre of the funds industry.'

The 39,000 funds that use FundSettle include hedge funds as well as the standard mutual funds, says Mr Nicora.

With 92 per cent of fund transactions through FundSettle now achieving STP, he claims a client signing up to the utility can save as much as 65 per cent on processing costs.

This saving may seem desirable, but while there are two major players in the market, fund companies may not be able to cut their costs as much as they might like. Frédéric Pérard, global head of fund services product at BNP Paribas Securities Services, points out that it has not been possible to choose a single platform. "In the French market, we work with Euroclear, but in Luxembourg we are more integrated with Clearstream."

For Mr Pérard, the challenge is for differing models of clearing and settlement – central securities depositary or transfer agency – to converge to a unified solution. "A lot of small actions are pushing in the direction of a big one. We should come to a solution across Europe in three to five years."

He complains, however, that to a certain extent, Euroclear and Clearstream themselves are part of the problem. "The position of Euroclear and Clearstream is not always crystal clear. Sometimes they position themselves as market utilities, sometimes as service providers competing with us."

Mr Pérard is interested in what DTCC has to offer this time around. "The way DTCC entered the market five or six years ago, that was a bit premature. Then open architecture [when distributors offer products from a range of fund managers, not just their inhouse provider] was in its infancy. Now the world has changed.

"Do they have the infrastructure?" Mr Pérard asks. "Europe is still a sum of markets. I don't see how it's going to be possible to offer a global solution."

Learning from the Lehman catastrophe

Interview

Jeremy Grant talks to the head of The Depository Trust & Clearing Corporation

The accepted wisdom is that the collapse of Lehman Brothers had catastrophic consequences because no-one had thought through, much less prepared for, a failure in the system of this size.

But at the offices of The Depository Trust & Clearing Corporation in New York in the summer of 2005, chairman and chief executive Don Donahue and a team of risk managers at the vast clearer and settlement system provider, had already been "war-gaming" just such a scenario.

Mr Donahue says that back then there were a "whole host of issues" that led him to think it would make sense for DTCC to have a few practice runs at dealing with a big bank liquidation, just in case something should happen. It was remarkably prescient.

"It was [a case of] just seeing all the numbers going up, in terms of volumes, in terms of clearing fund demands, of trading positions that people had. We really need to start thinking more about what our risk systems are capable of doing," he tells FTfm.

As a result, staff "went through a whole planning drill" at DTCC, which is owned by its 500 bank, brokerage and other financial services users. It provides clearance, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives. DTCC is also a leading processor of mutual funds and insurance transactions, linking funds and carriers with their distribution networks

But things did not quite go to plan over the US Columbus Day holiday in October of that year.

The idea was that key staff were to come into Mr Donahue's office and announce that they were part of the exercise and report how a particular aspect of the system was performing.

"And at 10.30 in the morning, the woman who was running risk at the time came in and said: 'I want to start this conversation by telling you that this is not part of the exercise'. This happened to be the day that Refco, the futures broker, was brought down after its chief executive failed to disclose huge debts owed to the firm. We immediately moved from what had been an exercise to the real life process," Mr Donahue says.

Thereafter, DTCC ran several similar exercises that stood it in good stead when Lehman collapsed. One of them actually worked through the possible collapse of Lehman. Mr Donahue explains why. "We were focusing on the larger firms. The whole point of it was 'worst case'. And, obviously, now we were in the post-Bear Stearns [the stricken US bank eventually bought by JPMorgan Chase] environment and that's when all the rumours were starting to fly. So it was kind of like, 'ok, Lehman fits the worst case group so let's try that'."

A few months later, Lehman's collapse was no longer a hypothesis. In the space of a few weeks, DTCC worked through $500bn (£349bn, €377bn) worth of exposures related to the investment bank and its counterparties, doing what a clearing house is supposed to do in default situations: netting down positions, becoming a buyer to every seller and a seller to every buyer and selling obligations into the market.

Don Donahue: a team had already been 'wargaming' a major failure in the system before the Lehman collapse Daniel Lynch

By October 30, DTCC was able to announce that it had closed out £500bn in market participants' exposure from Lehman.

Three lessons emerged from the process, he says. The first is that central counterparties are vital to prevent wider systemic damage in the event of a large default – a point now central to the rationale for a push to shift over-the-counter, or bilaterally negotiated, derivatives into a cleared environment.

Second, Mr Donahue suggests the experience of buy-side market participants with Lehman exposures could lead to them becoming members of DTCC and other clearing houses. Such players had huge profits on their positions with Lehman as their counterparty. Many expected DTCC to "make good" on their positions but, not being members, they had no claim and were forced individually to manage the liquidation of their transactions alone.

Finally, Mr Donahue says an issue that dogged regulators and banks during the crisis was establishing the extent of exposures and establishing basic information that could have led to a better response.

He says there were "absolute hysterics" in September about the size of the credit default swaps market and "how much of a black hole the Lehman situation was going to create". DTCC took the unusual step of issuing a statement making clear there was a central registry for CDS trades – at its trade information warehouse – where the vast majority of CDS trades are recorded.

Mr Donahue says this type of infrastructure could go some way towards dealing with the regulatory issues that have arisen over transparency. "There is a lot of information the [post-trade] infrastructure has that may be a partial answer to some of the re-regulatory impetus you are going to see unfold."

Rules of engagement becoming blurry

CSDs/Custodians

Some initiatives in Europe are altering the landscape in unforeseen ways, finds **Sophia Grene**

What is the difference between a central securities depository and a global custodian? This is not a joke, as in what is the difference between a raven and a writing desk. But the answer is no more clear.

Traditionally there has been no question of an overlap. The CSD is a market utility with two main functions: to ensure the existence of a security, checking the right number of securities are in issuance, that the issuer is legitimate and so on; and to facilitate the settlement of an exchange when a security is bought and sold.

The exchange of securities is no longer physical – if trader A buys a block of shares, she does not receive a stack of paper each worth one share – but electronic. Nevertheless, the piece of paper exists somewhere and is usually held in a safe by either the CSD or even the issuer.

The custodian has an entirely separate function, holding the security (once more electronically) on behalf of the client. Instead of a relationship with the issuer, the custodian will have an account with the client.

Changes in the European clearing and settlement landscape mean things are less clear-cut. According to industry commentators, this may have two implications. One is that custodians may face competition in some areas of their business. Concerns have also been expressed that recent changes, which could allow CSDs to take on functions involving credit and liquidity risk, might introduce unforeseen systemic risk into the financial system.

The CSD is traditionally limited to one asset class and often bounded geographically. Access to it is often regulated by the state and it must provide equal access to any qualified potential user. In Europe – a fragmented collection of states aspiring to a single market – this jigsaw of monopolistic providers is not ideal.

The Cesame group (the European Commission's clearing and settlement advisory and monitoring expert group) has called for regulators to do more to ensure post-trade clearing and settlement can function cross-border.

Charlie McCreevy, internal market commissioner, says: "The Cesame Group has played a crucial role in efforts to remove these barriers to post-trading, which should ultimately lead to lower costs for European businesses."

Florence Fontan, head of public affairs at BNP Paribas Securities Services, questions the means to this end. "The problem is how do we get from a monopolistic nationalistic structure to an entire European one?

"The [European] Commission refuses to forward consolidation by incentivisation. They say 'No, what I am going to do is create competition between CSDs and that may trigger consolidation and the best will win.'"

This is not an unreasonable expectation since there are obviously strong network effects in the success of a CSD – the more liquidity it provides, the more desirable it is but it has an unintended consequence.

In order to facilitate cross-border clearing and settlement, one CSD can now become the client of another. Where a German investor would previously have had to establish a relationship with an Italian CSD to trade Italian securities, it can now go through a German CSD. The German "investor" CSD, however, does not have a direct relationship with the security issuer but, rather, becomes a client of the Italian "issuer" CSD.

> 'On paper, CSDs will move up the chain and become custodians'
>
> **Florence Fontan, BNP Paribas Securities**

The issuer CSD's function is unchanged but the investor CSD has become a market participant analogous to that part of a custodian's function by which it manages the relationships with various CSDs.

This is less than desirable from the point of view of a custodian, because the CSD has a natural advantage. It has a monopoly on securities with whose issuers it has a direct relationship.

"On paper, CSDs will move up the value chain and become custodians while keeping those elements of the value chain the custodian does not have," says Ms Fontan.

In practice, Ms Fontan thinks this course of action is not so simple. Because of their background as utilities, CSDS are likely to find functioning in a competitive market challenging, she says. She also questions their ability to manage the banking business that custody entails.

Another concern is whether allowing CSDs to function as custodians might introduce systemic risk because they would have to take on credit and liquidity risk not mitigated by their balance sheets.

Whether or not this highly undesirable outcome has been foreseen, it no longer seems likely. Two integration initiatives are making consolidation more likely, which would mean an individual CSD functioning across borders rather than becoming a client of other CSDs.

Euroclear's rapid acquisition drive, which has brought it into several markets and allowed it to offer complete market integration between Belgium, France and the Netherlands, shows one way a single European CSD might be created. In the US, the monopoly CSD, DTCC, achieved its position by acquisition.

In another direction, and possibly not compatible with Euroclear's initiative, is the Target2 Securities programme announced by the European Commission, intended to create a central clearinghouse for a broad range of securities by 2013.

Custodians are also fighting back, offering more and more of the post-trade services traditionally part of the CSD function. For example, Citi's global transaction services business recently announced it would provide direct custody and clearing services to clients investing in the United Arab Emirates.