Competition, consolidation and change: key considerations in European securities clearance

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Competition in securities trading and clearing, the introduction of new trading venues and CCPs, and the repositioning of some market participants continue to fundamentally reshape the securities markets. The accelerated change driven by regulation (including EMIR and MiFID) continues to affect banks, broker dealers and clearers.

Five topics emerge as key considerations:

1. CCP Clearing fees
2. Interoperability
3. The future for equity CCPs
4. Segregation and portability
5. Central clearing for OTC cash instruments

What is behind today's CCP clearance fees and can they be sustained?

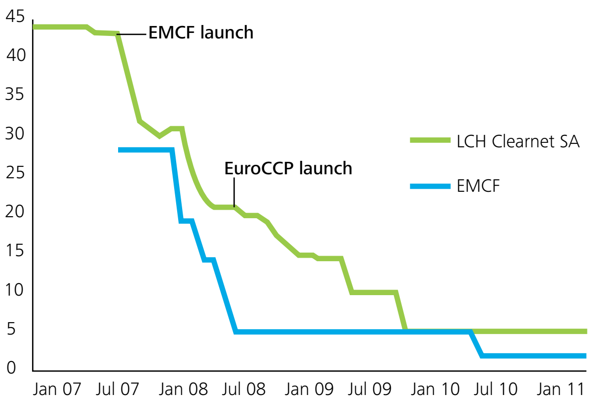
CCP clearing fees have decreased dramatically during the last few years, due primarily to regulatory-driven competition and interoperability:

- Starting in 2007, MiFID I spurred the creation of new trading venues and central counterparties in Europe. These new venues challenged the often national, near-monopolies traditionally held by stock exchanges and CCPs.
- Pan-European Multilateral Trading Facilities (MTFs) such as Chi-X, BATS Europe and Turquoise attracted the necessary liquidity for their markets by competing with the traditional exchanges on speed of trade execution and the cost of trading and clearing.
- Prior to the introduction of interoperability, a trading venue could only enter into an exclusive relationship with a single CCP. Here too, newly created CCPs such as EMCF and EuroCCP changed the rules through lower price models. These models were another important contributor to attracting trading liquidity to the new MTFs. The new MTFs and CCPs were symbiotic partners and as their combination attracted a greater market share, the traditional CCPs lowered their own clearing fees.

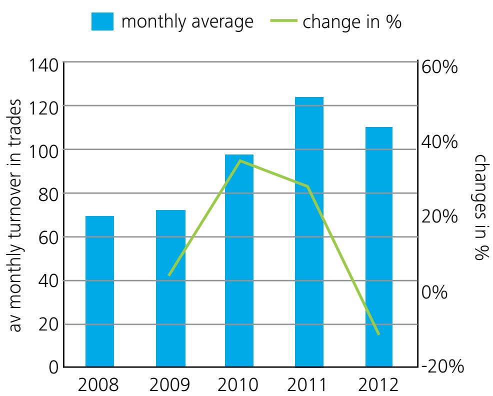
Competition increased when broad interoperability was introduced in Europe in 2012, driving CCP clearing fees further down as increased transparency caused these fees to become an even more direct instrument to attract business for CCPs. In fact, CCP clearing fees reached their lowest levels at the end of 2011 in anticipation of interoperability in early 2012.

Currently, the lowest CCP clearing fees in Europe are nearly comparable with those in the U.S. While that is largely viewed by market participants as a positive, there is another side to the story.

6 Year Decrease in Clearing Fees on European Equity Clearing CCPs vs. European equity Trading Volumes



LCH Clearnet SA fees represent the average clearing fee trend
Source: EMCF, LCH Clearnet SA, Spring Associates analysis



Today's low clearing fees are putting the profitability of equity-only CCPs under considerable pressure. Many CCPs today charge for auxiliary services (e.g. account maintenance and collateral handling) and may apply cross-product subsidies such that cash equity clearing is subsidised by derivatives clearing, if available.

So the question has to be asked: is this a sustainable business model for Europe's equity CCPs? Participants may well expect to see clearing fees fall further but it remains to be seen whether CCPs are able to reduce fees further without compromising the economics of their business model. One school of thought holds that clearing fees are more likely to increase; however, this would be a difficult commercial decision for CCPs, particularly those actively competing for interoperable trade flows.

If CCPs are unable to raise fees, the following options are available to them in order to maintain a healthy business:

- Lower costs
- Introduce new markets, products or services (for new sources of income)
- Find partners (mergers or take-overs)

We expect that most CCPs will be considering all three options, either separately or in combination with each other.

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Interoperability: will we see additional progress or adoption?

As a first step in ending exclusivity in the relationships between trading venues and CCPs, broad interoperability was implemented amongst a very limited number of trading venues and four European CCPs in January 2012.

Interoperability is an operational and legal arrangement between CCPs that enables clearers to consolidate transactions executed on multiple trading venues with their CCP of choice and therefore to optimise margin requirements for their trading members and bring further cost efficiencies. In theory, a clearer will only have one CCP relationship to maintain, one net settlement per ISIN, one consolidated margin requirement and collateral pool, and a single contribution to a default fund. Unfortunately, eighteen months after broad interoperability was first introduced, this ideal state is still largely aspirational.

For broad interoperability to succeed, more CCPs must subscribe to the operational and legal arrangements, and more trading venues must be willing to share their trade feed with multiple CCPs. Most venues have not met this goal; in fact, thus far the major regulated stock exchanges in Europe have not participated in any significant way, as embracing interoperability may impact their turnover and liquidity. Involvement by the major stock exchanges will be essential to achieving the expected benefits of interoperability.

The best way to push interoperability ahead is for members to put pressure on the trading venues on which they trade. The members bear today's high costs and will ultimately benefit from consolidation. The current restricted implementation of interoperability keeps costs higher than would otherwise be necessary.

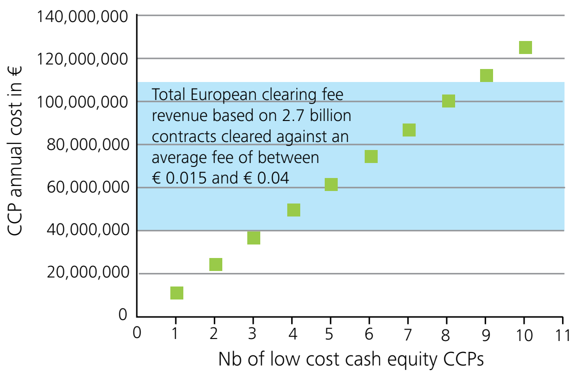
What does the future hold for cash equity CCPs?

Given lower clearing fees and limited interoperability, simple mathematics suggests that, using current pricing models, there are not enough cash equity transactions to be cleared to sustain the 15 cash equity CCPs currently active in Europe.

The graph on the right is based on 2012 statistics from the Federation of European Securities Exchanges (FESE). The light blue area covers the total equity clearing fee revenue for 2012 if all CCPs had charged competitive clearing fees. A low cost CCP will have an annual cost base upward of €12.5 million. This means that the total European volume can support no more than eight low-cost cash equity CCPs. Currently there are approximately 15 of those CCPs in Europe and they do not all operate on the same low-cost basis.

EMIR, or the European Market Infrastructure Regulation, is also forcing many CCPs to review (and perhaps reconsider) their business model. EMIR has introduced detailed rules and regulations for CCPs, including organisational requirements, risk mitigation measures and specified capital requirements. Under EMIR, all CCPs need to (re-)apply to the regulatory authorities for a formal European 'license to clear' by 15 September 2013. CCPs who cannot or will not want to comply with some of the new rules may exit cash clearing altogether.

Consequently, we expect to see additional CCP consolidation, whether through mergers, take-overs or other forms of cooperation. A recent example of this is the take-over of Oslo Clearing by Swiss based SIX X-Clear and, more recently, the announced merger between EuroCCP and EMCF.



What are the options for segregation and portability?

EMIR Article 39 directly affects securities clearance through requirements for segregation and portability. To summarise, clearers must offer their trading members the option to have their positions and collateral administered in segregated accounts (held separate from other trading members' positions and the clearer's proprietary positions). This will most likely become mandatory in the first quarter of 2014. Segregation in this respect must be upheld in the books of the clearer, and must also be maintained at the CCP. Segregation is intended to protect the trading member against the default of its clearer. Should a clearer default, the trading member's positions and associated collateral can easily be identified and transferred to a new clearer (portability). Therefore, the strength of the clearer becomes a critical factor in determining the need for segregation.

While the aim of building more client protection into the complex system of relations between the relevant market participants is commendable, this protection comes at a cost.

- CCPs must implement the new segregation protocols for positions and collateral. This will have significant technical, operational and legal implications. As a new service, it will most likely involve a new fee charged by the CCPs (some of which have already been published).
- Clearers will not only have to offer segregation—resulting in technology and operational changes—but will also need to demonstrate in legal terms to trading members that segregation offers the desired level of legal protection. Trading members who make use of this new service may also be charged a fee by their clearer for this.

Ultimately, market participants who are not self-clearing will have two choices:

1. Opt to segregate their positions and collateral at the clearer and CCP level and incur the extra costs, or
2. Opt to clear with a strong, stable and secure clearer whereby the extra layer of segregation and cost will not be necessary

Therefore, the strength of the clearer becomes a critical factor in determining the need for segregation

Will we see mandatory OTC securities clearing?

The shift to central reporting through trade repositories and clearing of OTC derivatives formalised in EMIR is intended to mitigate risk by increasing transparency into outstanding rights and obligations. Many market participants have asked the obvious: why shouldn't the same logic apply to OTC cash securities transactions?

The answer is provided in the MiFID proposals which indicate that clearing obligations for OTC cash securities transactions (equities and bonds) are likely to be adopted in some form at a future date (MiFID II, Level 1, Proposed Article 16.A).

In practice, however, OTC cash securities transactions can now be cleared centrally. The largest European CCPs already accept OTC transactions for clearing and settlement.

These services are not yet widely used since the CCPs require matched trade instructions in a specific format. To centrally clear an OTC transaction, for example, both the buyer and the seller have to register their side of the transaction with a so-called 'matching engine provider'. These service providers will then pass on the matched trades in the correct format to the CCP for further processing. These extra steps and relationships impose additional costs and the number of providers is limited. Additionally, should a trading member elect to centrally clear OTC cash transactions, the CCPs would require extra collateral to cover the margin requirements calculated for those positions, increasing the cost further. Nonetheless, market participants should keep in mind that, ultimately, a large part of OTC securities transactions are likely to be routed through a CCP in the coming years.

Market and institutional impact: conclusions

As a market leader in global clearance, J.P. Morgan works closely with trading members and market infrastructure groups to identify and assess the impact of ongoing market changes. We believe that clearers have an important role in providing trading members with up to date (as real time as possible) and transparent insight into their intraday credit and collateral requirements. They should work closely with trading members and infrastructure providers to support current and emerging business needs as the new global securities clearance model continues to take shape.

To the **point**:

- CCP clearing fees have reached their lowest levels for the time being. CCP focus for the coming year will be on consolidating the existing business and investing in new ones
- Interoperability has come to a stand-off between the large exchanges in Europe. Only the trading community can move things in the right direction, i.e. more trading venues participating
- There will be fewer, but highly regulated and strictly supervised, equity CCPs in Europe
- Segregation and portability will offer new protection to non-self clearing entities but will also raise costs. Alternatively, a strong and reliable partner can be chosen as a clearer
- OTC securities clearing will become commonplace within a few years