New challenges for securities and derivatives clearing and settlement

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Agenda

• OTC Markets and clearing
• Liquidity and collateral management
• Central Counterparties
• Clearing & Settlement – the European debate
• Overview European repo markets
OTC Markets and clearing
What are OTC Products?

- Over-the-counter cash (FX, Bonds, Equities,...)

- Over-the-counter derivatives are financial instruments not traded on an exchange whose values are derived from the value of something else.

- OTC markets have a crucial role to play in all national and international economies alongside and complementary to exchange markets. They have played a major role in global economic development and have been the hub of developments that benefit savers, investors, businesses and governments.

- In credit default swaps (CDS), the protection seller promises to compensate the protection buyer for the economic loss associated with a material decline in the value of a reference asset that is triggered by the occurrence of a predetermined “credit event,” such as a filing for bankruptcy or default on a debt payment by the issuer of the reference asset.
OTC products and the financial crisis

• Credit and other derivatives are in our view a symptom of the underlying problem rather than its cause.

• The market crisis is caused by a lack of confidence in financial reporting and by the actions or omissions of individual market participants – not by a lack of confidence in market structure or processing.

• Rather than rushing to develop new infrastructure, better and more extensive use should be made of the tremendous capabilities of the existing OTC market infrastructure, which has been battle tested and shown to operate very effectively, even at moments of severe market stress.

• The “turnkey” development of completely new market infrastructure is unnecessary and will require significant implementation time and incur a high level of risk.
Summary Observations

- The OTC markets play a crucial role in today’s economy
- Perceptions that OTC markets are unregulated are uninformed
- While regulatory overhaul in some areas is necessary, beware of ‘unintended consequences’
- Transfer of OTC trading onto exchanges is both impractical and likely to increase risk for those who are ill-equipped to manage it

- Concentrate on existing OTC infrastructure to: (a) simplify processes, (b) bring greater transparency and (c) increase robustness where needed
- **Over-riding issue:** wider adoption of CCP give-up and/or central clearing for OTC cash & derivatives
Other key issues:

1. Wider adoption of Electronic Trading
2. Quicker settlement cycles in all securities markets
3. Faster and automated affirmation/confirmation of all derivatives trades
4. Greater use of pre-book ing netting
5. Wider adoption of portfolio reconciliation
6. Wider adoption of portfolio compression in derivatives markets

Utilize the tremendous capabilities of the existing OTC infrastructure
## Clearing Benefits and Issues

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Issues</th>
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<tbody>
<tr>
<td>• Reduced credit risk</td>
<td>• Multiple clearing houses vs. single clearing house</td>
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<td>• Reduced collateral</td>
<td>• CCP capital requirements/robustness</td>
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<td>• Greater transparency over positions</td>
<td>• Standardised vs. non-standardised contracts</td>
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<td>• Reduced systemic risk and capital</td>
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<td>• Clearing house manages operational processes centrally for all</td>
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Many OTC markets are already cleared

<table>
<thead>
<tr>
<th>Cleared OTC markets</th>
<th>Clearing house/CCP</th>
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<tr>
<td>• Interest rate swaps</td>
<td>• SwapClear</td>
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<td>• US and EU government bonds</td>
<td>• DTCC, RepoClear</td>
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<td>• US and EU repo</td>
<td>• RepoClear, DTCC</td>
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<td>• Corporate bonds</td>
<td>• Euroclear, DTCC</td>
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<tr>
<td>• Equities/Equity derivatives</td>
<td>• Various incl. LCH, Eurex Clearing, OCC</td>
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<td>• Energy derivatives</td>
<td>• Nymex Clearport, LCH, ICEClear</td>
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Wider adoption of electronic trading

• The benefits of electronic trading are numerous:
  – price transparency is greater;
  – trade capture is simpler and can be automated more easily;
  – trade affirmation and confirmation are easier; and,
  – regulatory reporting requirements are easier to fulfill.

• Electronic trading needs to be adopted by more OTC market participants for more markets than at present.

• Electronic trading of credit default swaps in North America and of interest rate swaps globally would be a major step forward for the industry.
OTC products should not be required to be traded on an exchange

- The solution to current problems in financial markets does not lie in attempting to mandate the transfer of OTC trading onto exchanges.

- The OTC markets have traded, and need to continue to trade, separately from exchange markets for many reasons.

  - OTC markets are a vital risk management tool for governments, corporations, investors and individuals worldwide. Unlike exchange contracts, which are standardized, OTC contracts allow users to hedge risk precisely because they are individually tailored.

  - The experience of previous attempts to move OTC market trading onto an exchange format has been very poor. The majority of participants in the FX and CDS markets need the flexibility that OTC markets allow and cannot accept the standardization that exchanges enforce.

  - An exchange solution needlessly grants the exchange a monopoly on trade execution (which is usually accompanied by restricted access to clearing), which thereby leads to increased trading costs and risk and diminished flexibility.
OTC products should not be required to be traded on an exchange (continued)

- Exchanges provide a trading venue for assets that are simple and have characteristics that can be standardized.

- By contrast, OTC markets offer a deep and liquid trading venue for professional market participants, such as major banks and financial institutions, to execute transactions, the key terms of which are individually negotiated, rather than standardized.

- OTC markets are more attractive, and suitable, for hedging risk.
  - Since “real world” economic risk is normally non-standardized, traders who use exchanges for hedging purposes have to continue to live with the differential between their real underlying exposure and the payoff on their hedges. Users of the OTC markets can hedge their risk precisely and transfer to professional OTC market participants the residual risk they would otherwise be forced to live with if they had used an exchange product.

- Many OTC products, such as treasuries, are already cleared but not traded on an exchange.

- CCP and clearing house functions do not have to be tied to exchanges and these functions already provide valuable services to the OTC market, independently of an exchange, just as much they can as to the exchange traded market.
Collateral & Liquidity Management is defined as the optimal management of credit, collateral, capital and all related execution, pricing, operational, documentation and risk management of a portfolio across all products, all business units and all locations.
Liquidity and Collateral Management
Central Counterparties
Central Counterparty – The Benefits

Initial trade:
- Dealer A: 10 units X 100 euros
- Dealer B: 10 units X 100 euros

Novates:
- Clearer A: 10 units X 100 euros
- Clearer B: 10 units X 100 euros

- Immediate commitment, at the point of execution
- Principal to principal relationship
- Final commitment is with the Clearing Member
Advantages include:

- Reduction of the number of instructions sent on for settlement
- Reduction of the costs of the member's back-office processes
- Collateral optimisation: reduction of the risk exposure for open positions
- Netting ratios (number of instructions): Cash market up to 95% efficiency
Why a Central counterparty?

• Capital and Operational Efficiency
  - Maximises netting effect and facilitates balance-sheet netting
  - Maximises usage of collateral and frees up credit lines
  - Operational risks and back office costs are reduced through single counterparty

• Optimal Risk Management
  - A financial guarantee of transaction settlement
  - A single risk relationship
  - Daily marking-to-market providing risk management

• Related Benefits
  - Net settlement reducing costs and risks
  - Enables electronic trading anonymity
  - Members can also trade bilaterally but clear centrally through post trade confirmation systems
Clearing and Settlement
The European Debate
Clearing and Settlement – is it important?

- Giovannini working group – work on government bonds and repo markets at launch new currency
- Resulted in discovery of Clearing and Settlement issues – the Giovannini reports I & II
- Description of cl & settl process
- Risks in a cross-border basis
- Overview current arrangements
- Costs
- List of 15 barriers
- Commission used the 1st report and other work to adopt a communication regarding clearing and settlement to the Council and the European Parliament 28 May 2002
- Creation of Cesame group – replaced by Cesame 2 (Oct 20th 2008)
- Code of conduct, currently for equities only.
Timeline of Removal of Barriers

- Different operating hours/settlement deadlines
- Diversity of IT platforms/interfaces
- Absence of intra-day settlement finality
- Differences in standard settlement periods
- Different rules governing corporate actions
- Differences in securities issuance
- Conflicts of laws
- Legal treatment of netting
- Absence of EU-wide framework of laws
- Restrictions on tax collection
- Restrictions on withholding agents
- Restrictions on location of clearing and settlement
- Restrictions on location of securities
- Impediments to remote access
- Primary dealer restrictions

- Preparatory phase
- Removal phase

- Different operating hours/settlement deadlines: within 2 years
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- Preparatory phase
- Removal phase
The removal of the 15 barriers is essential for a fully integrated and efficient EU clearing and settlement arrangement.

- identify necessary actions
- establish appropriate sequencing of removal

3 types of barriers:
- technical / market practises
- taxation
- legal certainty
Basis of removal:

- importance
- inter-dependency
- specific action and responsibility
- co-ordination between different actions
- provide momentum & sense of urgency

Resulting in an optimal sequencing of removal of the barriers
Strategy for Removing the Barriers 3

- The sequencing applies only to the removal of the barriers.

- The preparatory work for removing all of the barriers will begin simultaneously in light of the fact that the strategy implies that all of the barriers must be removed within a three-year period.
Latest Developments

- Commission used the 1st report and other work to adopt a communication regarding clearing and settlement to the Council and the European Parliament 28 May 2002
- DG Competition input
- Creation of Cesame group – replaced by Cesame 2 (Oct 20th 2008)
- Code of conduct, currently for equities only.
- Analysis of fixed income & derivatives
- ESCB/CESR recommendations for Cl & Settl
- MiFID implementation questionnaire
The Markets in Financial Instruments Directive

- the corner stone of Europe’s drive for an integrated market
- establishes common framework for competition between:
  - exchanges (regulated markets)
  - multilateral trading facilities (MTFs)
  - investment firms/banks
- covers trading in all financial instruments (except FX)
Organization of the investment firm
Rules on outsourcing, mgt of conflicts of interests, personal transactions, record keeping, mgt of client assets and funds

Conduct of business rules
Information requirements, suitability testing, client document retention, client reporting

Best execution
Best possible result taking a/c of price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order

Client-order handling
Prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm

Client classification
Eligible counterparties, professional clients, retail clients
**MiFID 2**

**Transaction reporting**
To and between competent authorities only for those financial instruments admitted to trading on a regulated market

**Market monitoring obligations**
MTFs and regulated markets required to report disorderly trading, potential market abuse etc.

**Pre-and post-trade price transparency**
Transparency obligations established for investment firms, MTFs and regulated markets *only for trading in cash equities*

**Clearing & settlement access + choice**
(1) right of non-discriminatory cross-border access to C&S; (2) regulated markets to offer their members right to designate settlement system

**Capital requirements**
Investment firms to be subject to regulatory capital rules under the Capital Requirements Directive (Basel II capital rules)

**Regulation of regulated markets**
Organization, admission to trading/ removal/ suspension of financial instruments, membership and access rules, market monitoring
Overview European repo markets – 16th ERC survey
European Repo Council
16th European repo market survey
European Repo Council
16th European repo market survey

Source: FRBNY
Counterparty analysis

- Direct: 42.2%
- ATS: 28.2%
- Broker: 20.2%
- Triparty: 9.4%
Geographical analysis

- Domestic: 31.3%
- Eurozone: 24.1%
- Non-eurozone: 26.9%
- Anonymous: 17.6%
European Repo Council
16th European repo market survey

Collateral analysis

- DE 29.6%
- IT 12.2%
- FR 10.1%
- ES 4.9%
- BE 2.7%
- other EUR 8.7%
- UK 12.9%
- US 2.9%
- Japan 2.9%
- etc 13.3%
European Repo Council
16th European repo market survey

Collateral analysis

- other EU
- EU govis
Maturity analysis

- 1D: 18.3%
- 1W: 17.2%
- 1M: 19.9%
- 3M: 18.9%
- 6M: 7.6%
- 12M: 5.6%
- +12M: 1.8%
- fd-fd: 4.5%
- open: 6.1%
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