Interoperability for CCPs

A way forward

- ***Interoperability is vital to make European securities markets more efficient***
- ***EMCF is a proponent of interoperability***
- ***Interoperability requires inter-CCP risk management that mitigates risk transfer between CCPs***
- ***Existing interoperability models employ collateralisation and source collateral from participants' margins***
- ***In short term EMCF will implement a framework replicating the existing link for UK and Swiss equities***
- ***EMCF is supportive of EU legislation to harmonise CCP standards***
- ***EU legislation should introduce a single public model for interoperability that recognises the specific nature of a CCP***

EMCF

MiFID has significantly reduced the cost of trading and clearing in Europe

Following successful implementation of the Market in Financial Instruments Directive (MiFID), the European cash equities trading landscape has fundamentally changed. A number of new entrants at the trading and clearing level have increased the competitive pressure and helped to bring about fee reductions. They have promoted innovation and changed the industry by introducing Multilateral Trading Facilities (MTF) and pan European central counterparty clearing houses (CCPs). The success of MTFs such as Chi-X, BATS, Turquoise and Nasdaq OMX Europe has reduced spreads, driven growth in trading volumes and generated new opportunities for market participants.

Competitive pressure from new entrant CCPs has reduced cost of clearing significantly. EMCF – the largest CCP for on-exchange equities in Europe, clearing over 30% of European equity trading today – played an important role in this process. In some markets CCP tariffs have been reduced by more than 80%. Given the success of increased competition, one could ask the question whether interoperability is still necessary. We believe it is.

Fragmentation in trading requires consolidated clearing

Competition in trading and the emergence of new trading venues and CCPs resulted in fragmentation. Fragmentation can lead to participants having to face multiple margin requirements with different CCPs that clear the same securities. This adds to the complexity of best execution and adds to the cost of trading, whilst not serving any useful additional risk management purpose. CCPs could play an increasing central role in allowing trading participants to trade on a multiple of platforms and consolidate risk exposure and settlement operations at a single point of entry.

Interoperability is the tool to facilitate further consolidation and competition

The European Code of Conduct for Clearing and Settlement introduced the concept of interoperability. Interoperability allows customers to consolidate clearing volumes and risk exposure from venues cleared by multiple CCPs into a single entity. This promotes consolidation, thus eliminating fragmentation of clearing and multiple margin calls. Interoperability plays a vital role in the strategy to make European securities markets more efficient. It establishes direct competition at the clearing layer and creates a level playing field for CCPs.

EMCF is a proponent of interoperability

As the first pan European CCP, EMCF is a firm proponent of interoperability and has been involved in building new links from a very early stage. It is important for EMCF as an enabler to compete for exchange and MTF trading volumes. EMCF supports a level playing field for CCP services, with mutual and reciprocal links. EMCF also recognises the need to develop a solid risk management model that does not introduce additional systemic risk and that does not incentivise CCPs to compromise risk management for competitive reasons.

EMCF is in ongoing negotiations on interoperability with several European CCPs. These initiatives have recently been suspended following regulatory concern regarding risk exposure between CCPs. Regulators are currently assessing the inter-CCP framework, with an emphasis on the inter-CCP risk management. The regulators of The Netherlands, Switzerland and the UK have put forward a joint statement indicating that more work needs to be done by the CCPs to provide insight into the mechanics of the interoperability links and the systemic risks associated with the operation of these links. On behalf of EMCF this document forms part of the effort to create a common understanding of the requirements for interoperable links.

Interoperability requires inter-CCP risk management that mitigates risk transfer between CCPs

CCPs are at the heart of the financial infrastructure and a spill-over of risk between CCPs could disrupt the stability of the financial system. Interoperability would introduce an exposure to a different type of counterparty than the regular clients of a CCP. A prerequisite for interoperability links is to mitigate the risk of a domino effect in case of the unlikely but severe event of a CCP default.

The prime purpose of a CCP is to protect market counterparties against the impact of each others' default. The introduction of interoperability does not in itself increase the risk of participant default. In this sense interoperability should not lead to an increase in the overall risk that the CCPs manage. The challenge is to devise an approach that achieves this objective.

Interoperability requires inter-CCP risk management providing adequate protection against market, operational and other risks. Recommendation 11 of the CPSS-IOSCO recommendations for Central Counterparties requires interoperable CCPs to ensure that the risks are managed prudently on an ongoing basis. This is in addition to the CCPs' defence lines that ensure that the CCP can endure extreme market conditions. Any inter-CCP risk framework for interoperability should therefore be carefully designed, on the basis of mitigation of residual risks in case of a CCP default.

An inter-CCP risk management framework that builds on collateralisation requires CCPs to post collateral with counterparty CCPs. These inter-CCP margin calls will bring about significant credit requirements for CCPs. CCPs are natural pools of liquidity that operate settlement networks involving numerous liquidity requirements and credit lines. However, inter-CCP collateralisation is a different type of obligation for a CCP. There is a trade off between the cost of this obligation and the benefit of consolidation of clearing volumes. Consolidation of clearing volumes through interoperability reduces the risk of open settlement positions for participants significantly. At the same time interoperability introduces an additional risk between CCPs that is ultimately carried by the participants of a CCP through their default contributions.

Existing inter-CCP risk management models employ collateralisation and source collateral from participants' margins

There are existing interoperability arrangements between CCPs in Europe. Examples of those links are; for equities between SIX X-Clear and LCH Clearnet Ltd, for fixed income between CC&G and LCH Clearnet SA and for derivatives between Oslo Clearing and LCH Clearnet Ltd.

To determine adequate mitigation of the exposure over the interoperability link in the current absence of common CCP standards, risk management methodology is employed that is similar to the methodology used for regular participants. In some links co-operating CCPs are regarded as clearing participants under each CCP's margin methodology. Other links employ a single margin methodology between the CCPs.

On the basis of the standard margin system, a CCP has to fulfill a margin call for its exposure towards the counterparty CCP. This exposure amounts to the net position of the underlying participants versus the net position of the participants of the counterparty CCP.

The current practice to provide for inter-CCP collateral is to make use of participants' collateral in some form. Different CCPs have different methods of sourcing credit and liquidity – whether they reuse the collateral with participant permission or such collateral legally belongs to the CCP. All links however share the principle of access to the collateral provided by participants, in order to avoid the use of shareholder funds.

Handling inter-CCP exposure: control systemic risk with adequate collateralisation

EMCF is engaged in advanced negotiations to implement interoperability links with three CCPs: EuroCCP, LCH Clearnet Ltd and SIX X-Clear. In order to speed up the development of these links the proposed inter-CCP risk management framework mirrors the interoperability link between LCH and X-Clear for cash equities. This implies that each CCP would use its standard participant margin methodology and collateralisation to provide protection against a potential loss in case of a default of the counterparty CCP.

The margin calls require CCPs to post collateral with their counterparty CCPs. The CCPs will assure that the quality of collateral is sufficient and of high quality, in order to ensure that the performance of such collateral can be maintained even in extreme market conditions.

Collateral sources: from the market for the market

Different CCPs manage participants' collateral in different ways and even within any one CCP the legal approach used can vary between different forms of collateral. The ability of a CCP to post some of the participants' collateral with another CCP therefore varies between CCPs. In the case of EMCF, all collateral is held in the name of the clearing participant. The legal framework excludes use of cash or securities deposited at EMCF other than in case of a default of the participant. Therefore, the participants' collateral is not available to be posted with other CCPs under the current arrangements. Other CCPs may either have a broader ability to make use of collateral in circumstances other than default or may hold the collateral in the CCP's name rather than the participant's name, and therefore have full control over the funds.

EMCF envisages changing its collateral holding structure to allow the use of client funds to collateralise the link, replicating existing models. The changes to the legal framework will enable EMCF to source the liquidity and credit lines needed to provide collateral to counterparty CCPs from a part of the collateral holdings of EMCF participants. The changes to the collateral holding structure are subject to regulatory approval.

EMCF will be fully transparent to its participants

Market participants and platforms have expressed their concerns about the transparency of certain aspects of the inter-CCP agreements. EMCF supports full transparency to clearing members and trading platforms of the risk management paragraphs of a clearing link agreement.

The changes to EMCF's legal framework and participant agreements will be discussed with a representation of the EMCF participant base over the coming weeks. EMCF invites its participants to provide their input for this process in order to facilitate a framework that mitigates additional risks, promotes efficiency and suits the participants' requirements.

Towards a future interoperability framework

EMCF is an advocate of European legislation that includes 5 key elements:

Regulation is currently fragmented throughout the member states of the European Union. EMCF is a proponent of the Commission's proposal to harmonise CCP legislation in the EU. This would significantly enhance the regulatory transparency of operating a pan-European CCP and facilitate a level playing field. EMCF is engaged with regulators throughout Europe to promote harmonisation in Europe. EMCF calls for legislation that facilitates adequate regulation for CCPs in the European Union that recognises the following topics:

1. Regulatory framework mandated by law

CCPs should be subject to a regulatory framework mandated by law. Harmonised legislation in all EU countries would fit the strategy to promote a single European financial market, and enhance the legal certainty for CCPs and participants and reduce the risk of regulatory arbitrage in Europe.

2. Passport rights

Exchanges, MTFs and investment firms subject to national legislation can passport their license throughout the EU based on home country regulation. This is currently not possible for CCPs, which are assessed on the basis of Member State legislation. EMCF operates a regulatory network that encompasses multiple jurisdictions. The regulatory authorities involved with EMCF cooperate on the basis of memoranda of understanding which aim to prevent duplication of oversight. The regulatory harmony in Europe functions well in most cases as was demonstrated by the introduction of the Nordic CCP in three different jurisdictions by an entity under regulation from two other authorities. Still, the requirements put forward by some regulators prevent a level playing field in Europe. EU legislation should grant passport rights to CCPs to combat regulatory fragmentation.

3. Minimum standards of oversight and risk management

All CCPs currently agree that competition on risk management should not take place, yet there is de facto competition on this within the EU. Some risk management practices are allowed in some countries and not in others, which results in differences in margin requirements that can reach levels of over 100% for the same portfolio. Minimum quantifiable standards of oversight and risk management would eliminate competition on risk and avoid regulatory arbitrage.

4. A definition for a CCP as an entity that does not take risk positions

CCPs should have a well defined status that recognises it is a different counterparty than a risk-taking intermediary. Adequate insolvency procedures embedded in law and the obligation to minimise impact after default by mandating the defaulting CCP to close its balanced positions, should reflect their special nature of CCPs. This should be facilitated by a common view on capital adequacy of CCPs regulated in the various countries.

5. Single public model for interoperability taking into account the status of a CCP as a special market infrastructure

There should be a single public model for interoperability across the European Union, rather than the private bilateral arrangements that exist today. This model should also recognise that CCPs are entities that are subject to specific regulation and are therefore different from risk taking intermediaries.

When regulation sets minimum standards of oversight, the efficiency of inter-CCP links could be increased without compromising safety by replacing the current collateralisation model with a more efficient interoperability model that takes into account the existing defence lines of a CCP under strict supervision from regulatory authorities and central banks in Europe.