



# Competition or Consolidation?

## The Outlook for Interoperability Among European CCPs

Taking effect in November 2007, the Markets in Financial Instruments Directive (MiFID) made great strides toward reducing the cost of trading on European markets. The emergence of Multilateral Trading Facilities (MTFs), the new pan-European trading venues, will increase competition and may reduce trading fees.

With the corresponding fragmentation of liquidity, the post-trade environment has become increasingly complex as the MTFs have appointed new entrants into the central clearing party (CCP) space. As a result of this new CCP competition, infrastructural clearing fees have decreased; however, overall trading costs have actually risen. Increased complexity and market fragmentation are driving up costs for technology, operations, staffing, data and the higher risk of increased fails and penalties.

Until recently, almost all European clearing remained siloed. With very limited exceptions, each traditional exchange had an exclusive clearing relationship with a single CCP, which, lacking competition, was free to dictate clearing fees. To make matters worse, participants that trade across multiple exchanges had no opportunity to gain volume discounts by consolidating their clearing flow. They also had to manage multiple CCP margin calls without the opportunity to offset corresponding trading positions and with limited settlement netting opportunities.

### Moving toward U.S. levels of post-trade efficiency

As a result of the siloed post-trade environment, trading on the European markets remains complex and expensive,

### INTEROPERABILITY



European Market Infrastructure Regulation (EMIR) defines interoperability as “an arrangement between two or more CCPs that involves a cross-system of transactions.”

particularly relative to U.S. markets. The U.S. economy produces roughly the same GDP as the European community. Yet the companies representing that GDP are quoted on four systemically important trading venues in the U.S. versus 28 in Europe. For equities, the U.S. uses one CCP and one securities depository in contrast to 23 CCPs and 40 central securities depositories (CSDs) in Europe.

To achieve similar levels of transparency and efficiency, European markets need to move toward a more competitive clearing system where participants are free to clear trades on multiple exchanges through a preferred CCP.

Interoperability of major European CCPs is the first step toward this goal.

Interoperability allows trading firms to clear trades on multiple European markets through a single CCP of their choosing. CCPs that choose to interoperate must first establish arrangements with one another via an interoperable link and also connections with the exchanges for which they clear trades. That allows users of one CCP to execute and clear trades with a counterparty that has chosen another. As these CCPs must now compete for market share, interoperability should drive down clearing fees, improve service quality and foster innovation.

In essence, interoperability fulfills the original, larger promise of MiFID Level 1. Peter Rouwen, executive director

for new business development at J.P. Morgan notes, “The intent is to enhance transparency and reduce the total cost of trading, including execution and clearing, across the entire European community.”

### A beachhead for interoperability in Europe

On January 6th of this year, the European market infrastructure took a critical step toward more interoperability when four major CCPs — EMCF, SIS x-clear, EuroCCP and LCH.Clearnet — became fully interoperable. “Market participants can now choose any of these CCPs to clear the majority of their trades on the major European MTFs, including BATS Chi-X Europe, Turquoise and, in short order, NASDAQ OMX,” says Michael Albanese, head of global clearance at J.P. Morgan.

With the European trading and regulatory communities watching carefully, these efforts will help to establish whether interoperability yields the promised efficiencies in a real market setting. Should the multiple interoperable CCP model be proven, it is hoped that a rapidly growing number of CCPs will join the fray. Attention now shifts to the major exchanges in Europe that have not adopted interoperability.

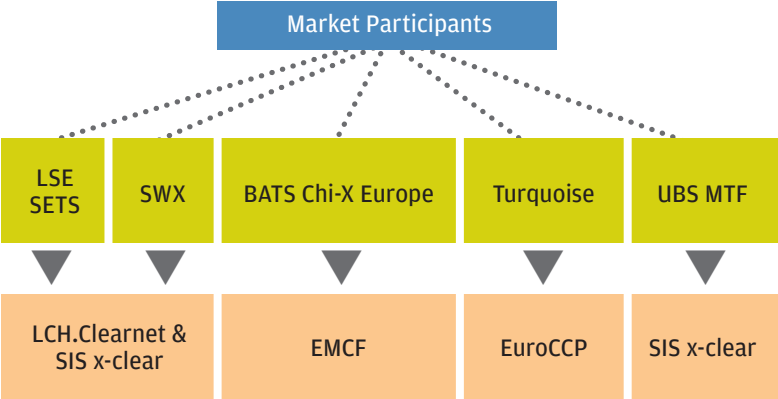
### Transition issues and unintended consequences

The full benefit of interoperability cannot be realized until *all* trading venues provide their trading flow to more than one CCP. There is likely to be an extended transition period between the current state and the formation of a fully interoperable post-trade environment, should it ever come. During this transition an additional degree of complexity will be added. Consider a large order that is split among three exchanges which are cleared by interoperable CCPs and one exchange that is cleared by a CCP that is not interoperable. The three fills would be amalgamated to create volume efficiencies and netted to potentially reduce the margin calls. The fourth fill would still have to be cleared and settled in isolation. Clear designations must be made to know which parts of which trades will be handled by the preferred CCP and which will not. According to Mike Reece, European markets executive for banks and broker dealers at J.P. Morgan, “This transitional period could last for years, with no diminishment to complexity.”

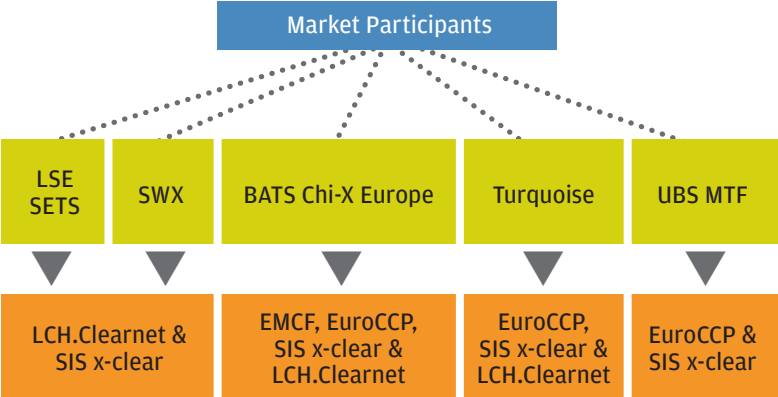
On a broader scale, there is some concern as to whether competitive pressures brought on by interoperability will reduce the revenue CCPs need in order to maintain a robust infrastructure, provide adequate risk management systems and deliver other essential market functions. The last thing the markets need is an environment that is conducive to CCPs competing on risk, resulting in a race to the bottom. Interoperable links require the linked CCPs to be

## European Market Infrastructure

### PRE-INTEROPERABILITY



### POST-INTEROPERABILITY



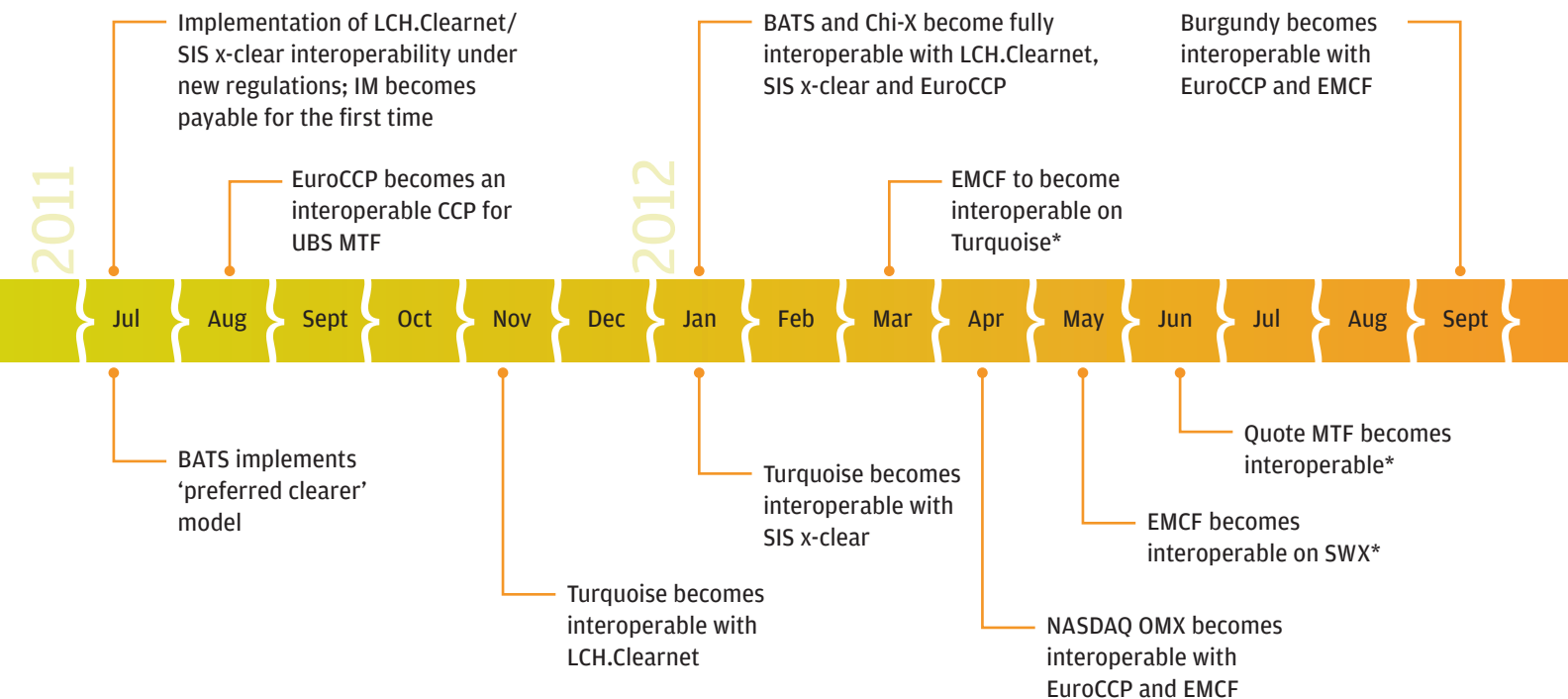
■ Trading Venue Interoperable ■ CCP Interoperable

comfortable with each others’ risk management systems and to fully collateralize the activity across the link. As a result, interoperability may lead to a wave of consolidations and closures as CCPs are caught between the need to compete on price and the need to enhance services while maintaining robust risk management systems and being subject to increasingly stricter regulatory regimes. “Theoretically,” Reece notes, “such a consolidation could lead to increased leverage and pricing power amongst the remaining CCPs. At the very least, a considerable amount of uncertainty has been injected into the system.”

### General Clearing Members (GCMs) and the enormous efficiencies of scale

The introduction of interoperability will not change one fundamental maxim of the European post-trade environment: clearing is a volume game. Every major CCP employs some manner of tiered-fee structure based

## European Interoperability Timeline



\* Estimate

on the volume of trades cleared. According to Rouwen, "Interoperability can only expand the field on which the volume game is played." Given the extreme efficiencies of scale, it makes sense that some of the world's largest market participants have allied with GCMs rather than clearing independently. By amalgamating volume from a broad range of market participants, GCMs can direct extraordinary volume through a single CCP, driving down clearing costs for all of their clients. Any but the largest tier-one banks that choose to clear on their own — as well as non-clearing members using the service of a GCM with lower clearing volumes — place themselves at an enormous competitive disadvantage.

Alongside their advantages in scale, GCMs offer complementary services that make them a more viable solution for most participants. These include efficient, centralised collateral management programs across different asset classes for both cleared and non-cleared OTC derivatives products and netting opportunities for processing the on-exchange settlements.

In addition to amalgamating volume, GCMs are well positioned to assess the relative strength of CCPs and choose the most robust one according to their own risk criteria. This reduces operational risk and avoids exposure to multiple CCP loss-sharing arrangements. As this is likely to remain a steadily evolving situation for years to come, it's important for traders to assess the relative commitments and staying power of the various GCMs. At a minimum they should be comfortable that the GCM has

the size and stability to deal with defaulting counterparties, has the infrastructure to add efficiencies across the entire post-trade environment, and has the wherewithal to stay the course as clearing in European markets moves — in fits and starts — toward greater interoperability.

### A long-term commitment to an evolving process

In January the European trading community took a great step forward. In providing traders with the opportunity to consolidate clearing activities through a single CCP, traders should be able to reduce clearing fees, improve post-trade efficiencies, and reduce some of the complexity introduced by MiFID Level 1. Albanese states, "J.P. Morgan is committed to helping our clients participate in the benefits of interoperability now and as the situation evolves. As one of the largest GCMs, we are able to act as a uniquely effective concentrator of clearing flow. Combined with a robust collateral management and custody infrastructure, J.P. Morgan is ideally positioned to help our clients take full advantage of these promising developments."

"The only real certainty is that the landscape will continue to evolve, creating both improvements and unplanned challenges for all market participants," says Reece. "Clearing banks can provide an important layer of continuity, and this role is a key focus for J.P. Morgan as we move into this next phase of change." ■



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