

# cost and risk in clearing and settlement



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## Q&A with JPMorgan's Ed Corral

### What are the appropriate roles of risk takers and risk mitigators in the clearing and settlement process?

Securities settlement across the globe continues to evolve from stock moving free of payment to movements being made against payment. The registration of beneficial ownership has also evolved from bilateral contracts between individuals through registrars and centralized registry systems to book-entry systems run by central securities depositories (CSDs). These depositories provide further assurance that the paper or 'right to stock' received is valid and that ownership is transferred correctly.

On the clearing side — defined as the function of novation and guarantee typically performed by central counterparties (CCPs) — the introduction of CCPs has allowed market players to significantly mitigate the risk of price variations between trade and settlement date through margining, as well as to virtually eliminate counterparty risk.

Both of these functions are essential to the correct and secure operation of the capital markets. There are a number of past examples where inefficiencies in the clearing and settlement infrastructure have led to real losses — every transaction and bankruptcy tests the robustness of a clearing and settlement infrastructure. One of the reasons capital markets have continued to grow over the past few years is their robustness and resilience.

### Where do the risks lie?

The established cash capital markets in Europe and the United States are generally well-structured, with clear ownership of outstandings in bankruptcy situations. In these markets, the risk premium becomes quantifiable and approaches zero. However, one key area is often unexplored: the steps that need to be taken to translate the risk that a broker or hedge fund represents when trading into a settlement guarantee.

There is a clear difference today between the risk an infrastructure is willing to take — or indeed *should* take — as a guarantor underpinning the security of the financial markets, and the highly regulated financing and credit risk banks take when representing their clients for settlement. An infrastructure, for example, would look to settle as close to central bank money as possible, whereas a highly leveraged hedge fund will typically not want central bank money owing to access limitations resulting from the nature of their activity, capital base or appetite to pre-fund activity and tie up collateral against settlements. They must buy that facility from a bank or financial institution.

Who the providers of clearing and settlement should be, therefore, depends on their role in the clearing and settlement process. They may act as risk mitigator, or as risk taker or transformer, in either clearing or settlement.

### Clearing

CCPs need robust systems and operations and precise risk management algorithms to offset the very high levels of price and counterparty risk they take in their role as the counterpart to an entire market or number of markets. They are risk mitigators for the marketplace. CCP clearing risk is allayed by margining, default funds and any number of different financial constructs.

However, a CCP takes intraday and overnight financing risk through margin payment exposure against its clearing members, making it — to a lesser degree — also a risk taker. This financing risk needs to be reduced as much as possible so as not to put the market at risk. Consequently, CCP membership is restricted, typically with balance sheet size providing a proxy for financial strength.

intraday or overnight finance on a partially or wholly uncollateralized basis. These banks are risk takers in the settlement space.

In both clearing and settlement, therefore, risk mitigators and risk takers have historically played very different roles — with infrastructures acting as risk mitigators, while agent banks are risk takers. It is difficult to see how the two can truly overlap without introducing inefficiencies in the marketplace. As infrastructures expand their services, their risk-taking activities should be at the forefront of scrutiny by regulators, users and shareholders. The systemic risk that would be introduced by a blurring of borders between the two functions needs to be carefully examined by all stakeholders.

## “Self-regulation may not be enough for market infrastructures.”

Those trading entities that are not eligible for CCP membership then need to ‘buy’ access to the clearing system from a CCP member, often a bank. The bank effectively provides margin payment guarantees and thus assumes the risk between the trading member and the CCP, transforming risk and becoming a risk taker. The two functions, CCP as risk mitigator and CCP members as risk takers, have little overlap.

### Settlement

In the settlement arena, depository and settlement systems also need robust systems and operations. Both systems must move as close as possible to settlement in central bank money to fulfil their role as guarantor to the marketplace and avoid having to unwind marketwide settlement processes if one participant does not pay its dues. Although rare today, this did occur with some frequency in Europe during the 1990s.

The number of entities in any given market with access to central bank money is, however, restricted. Technology, the cost of collateral and the rigidity of prefunding requirements all play a role here, as do central bank rules themselves. Entities that cannot or do not wish to access central bank money find themselves buying settlement and the associated financing services from banks that have access and are willing to extend

### And how can regulatory action help mitigate risk?

In both the risk taker and the risk mitigator arenas, regulation should correspond to the level and type of risk taken by each player. We welcome the European Commission’s decision to propose a Code of Conduct as opposed to a new Directive in the post-trading area. Banks are already heavily regulated in their role as risk takers. Additional regulation should only be proposed when there are clear risks demonstrated that are not already covered by existing regulations.

In the absence of an industrywide Code of Conduct, however, self-regulation may not be enough for market infrastructures, especially those that are privately-owned and answer to shareholders’ demands. Users’ interests and views must be protected; hence, some form of light and well-considered legislation may be more appropriate than self-regulation for infrastructures in their role as risk mitigators.

In conclusion, this distinction between risk mitigators and risk takers is and should remain an important distinction between infrastructures and banks. ○○○