Interoperability

More questions than answers?

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The closer, the better

In November 2006 the clearing and settlement industry demonstrated its commitment to creating transparency, interoperability and competition with the signing of the Code of Conduct (the Code), a move that received the full backing of the European Commission.

Yet to be born

Although the Code stipulated that access and interoperability measures would be implemented by June 2007, steps towards achieving competition and interoperability remain at the embryonic stage.

The ultimate aim was to offer market participants the freedom to choose their preferred provider of services separately at each layer of the transaction chain (trading, clearing and settlement). But today market participants still face a region with over 20 equity trading venues and 10 central counterparties (CCPs). To offer best execution across the FTSE100 for example, a broker needs single order router into seven venues and clearing on three CCPs! It would seem that more questions have been raised than answers.

We examine the barriers to interoperability and the solutions available to market participants as the debate swings from the industry-led Code towards regulatory intervention and the possibility of a European directive.

If there's a will, is there a way and at what cost?

Some CCPs have certainly shown willing in their attempts to create inter-house links but progress remains slow for a myriad of reasons.

It is now widely recognised that interoperability creates additional risk. In February this year the Dutch, Swiss and UK regulators issued a supervisory letter calling for these risks to be mitigated with additional collateral to that already provided to cover members' risks.

Whilst CCPs are certainly capable of establishing an effective margining methodology to address this concern, the questions remain: at what cost and who will bear this cost?

Which road to take?

Regulators are also calling for a single model for interoperability, yet there appears to be no consensus on the preferred methodology for achieving additional collateral – the augmentation of default funds or the charging of supplementary margin sums from participants. Either way, who will pay what price?

There has been a great deal of collaboration amongst the CCPs on the road to interoperability, but it is still unclear in which spheres they will cooperate and where they will compete. It certainly makes sense to agree on operational procedures, corporate action processing, partials, shaping and buy-ins – these are not areas where a CCP can gain a competitive advantage.

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We understand that they are not going to compete against each other on risk, but this is central to the CCP role and it is difficult to imagine how they can compete with each other without competing on risk.

Which way will the pendulum swing, and when?

CCPs may buy in to the end game – offering their clients access to all venues – nevertheless the market continues to fragment at a faster rate than it consolidates. This month's announcement by NYSE Euronext that it will be establishing its own clearing houses being the latest example of disintegration. With the continued proliferation of clearing houses and no apparent consensus on the intermediate steps towards the end goal, it is difficult to envisage the multilateral approach needed to create an open playing field across the region.

Interoperability is perhaps receiving more than its share of air time as regulators and the industry continue to grapple with the complexities of cross-border trading. The pendulum appears to be swinging back and forth from vertical silo through interoperability to pan-European CCP, almost from one day to the next. The priority for market participants challenged with this environment has to be achieving the most cost-effective and risk-mitigated clearing across Europe's multiple markets.

BNP Paribas Securities Services – sheltering you from market complexity and cost hazards

The arguments for appointing a general clearing member (GCM) to minimise capital requirements and limit your liability have never been stronger. Because they are member of both an exchange and all its associated CCPs but only focus on clearing flows from other trading members, GCM can quickly build critical size and cost savings in post trading.

With BP2S, a member of all Europe's CCPs, you have easy and cost-effective access across the region. You are assured of fixed rather variable trading member costs. We bring maximum flexibility, enabling you to quickly switch from one CCP to another as the competitive advantages change.

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