Balance of power

Europe’s securities industry is transforming itself at breakneck speed into a much more competitive arena. But is the post-trade world moving fast enough to keep up? Here DIANA CHAN explores the issues.

The European securities industry is in the middle of a big rehab project. It’s as though the building inspectors came along and said: “This structure is basically sound, but the plumbing and wiring need to be replaced. It was all built to old-fashioned local specifications. Now you need to bring it up to the new pan-European code.”

In this case, the plumbing and wiring are the post-trade systems that Europe’s stock exchanges and the emerging set of multilateral trading facilities (MTFs) rely on to make sure their trades are cleared and settled. The building inspectors are from the European Commission. And the “code” is the Code of Conduct that the European securities industry agreed to adopt 18 months ago in order to make clearing and settlement a more innovative and competitive business without the need for legislative intervention.

So far, however, this rehab project isn’t going quite as planned. Instead of the broader business the Commission envisioned, where clearing organisations are able to compete for processing volume from the exchanges, the industry’s reaction has mostly been to cling to its old plumbing and wiring. The derivatives markets, which are outside the scope of the Code, have even gone in the opposite direction. Rather than allow other organisations to clear their trades, as the Code of Conduct stipulates, the exchanges are talking about creating entirely captive clearing units. In other words, they want to build new structures and then wire them the old-fashioned way so they can’t be hooked into the broader “power grid.”

Commission warning

This perceived snail’s pace on implementing the Code has already prompted a warning from Charlie McCreevy, the European Commissioner for Internal Market and Services. Speaking at a joint European Commission – European Central Bank conference in April, McCreevy suggested that progress on the Code has been “encouraging.” “But,” he added, “endless foot-dragging is not going to be acceptable. I do not think I need to remind the industry that the Code is the last chance they have to prove that they are capable and mature enough to provide adequate solutions to the current issues.” Translation: if you can’t sort this out yourselves, we’ll turn it over to the regulators.

The Code of Conduct is actually the second step in the European Union’s two-step effort to remove longstanding national and regulatory barriers to competition within Europe’s securities industry. Step one was the introduction last year of the Markets in Financial Instruments Directive (MiFID). Not only is it brushing away old, anticompetitive barriers from Europe’s nearly 30 exchanges, but it’s also injecting new life into the market by permitting the creation of entirely new exchanges or multilateral trading platforms to compete with the existing exchanges. The thinking is that, first, MiFID will drive more competition among Europe’s many exchanges, and then, second, the Code of Conduct will allow for more competition among the post-trade infrastructures that support those exchanges.
The end result, according to the plan, should be a lower cost of raising capital for issuers and of trading in securities for investors in an integrated, pan-European capital market.

The problem, however, is that while MiFID is a regulatory requirement, the Code of Conduct is voluntary. If you don’t want to upgrade your old wiring and plumbing so that your customers can get to other utilities and service providers, you don’t have to.

MiFID, by comparison, is having a huge impact. Europe’s markets are compressing into just several years the kind of liberalising change that other markets took decades or longer to introduce. The cash markets will have a number of pan-European multilateral trading platforms. Chi-X, in business since March 2007, will be joined by Turquoise, an MTF owned by a consortium of the world’s largest broker/dealers. Others are preparing to launch as well, including SmartPool, Nasdaq OMX, and BATS Trading, each with its own business model to compete with established exchanges in the post-MiFID world.

The question now is what happens when this blast of competition reaches the post-trade world? What will investors think when they see rising volumes and sophisticated new products forced into old and unresponsive local plumbing and wiring, most of which was designed specifically to avoid competition and is therefore expensive?

Will the Code of Conduct, which stipulates that an exchange cannot give any single central counterparty, including one that it owns, the right to clear all its trades, have any impact at all?

To answer this question, it might be useful to see what happened in US markets after the equivalent of a mandatory Code of Conduct was introduced there in the mid-1970s. At that time, America’s market looked more like Europe’s today. Then the new regulatory requirement was introduced. Unlike the Code of Conduct, which is voluntary, the new rule stipulated that the various existing clearing organizations in the US market had to interoperate.

**Historic lessons**

What followed were years of intense competition among clearing providers in the US market. Many of these providers were linked to particular markets, but all had to be interoperable. It was this very competition that drove the consolidation of clearing in the US. As the years went by, broker/dealers and other trading parties grew tired of having to post separate collateral at each different clearing house. They wanted out of vertical silos. They wanted more efficiency and less risk. They wanted more consolidation.

Whether Europe’s markets will follow this same path is a question for the crystal ball. Interoperability doesn’t inexorably lead to consolidation. But it doesn’t take a crystal ball to see that the very market forces that the Code of Conduct seeks to stimulate in Europe are essentially what drove exchanges in the US market to eventually forgo their clearing operations and focus on the trading side of the business. And what are these market forces? Cost, risk and competition.

Before too long, cost is likely to become a more critical factor in Europe’s trading equation. The cost to clear an equity trade in the US market is six-tenths of a penny (.0038 euros). The cost to clear that same transaction in Europe’s markets right now is likely to be at least twenty to thirty times as much. As hedge funds and other European investors increase their trading volumes, the cost of trade execution becomes a more serious concern. Exchanges cannot escape this pressure, because increased competition among exchanges and the new multilateral trading platforms is likely to drive down trading fees. And more competition among post-trade clearing organisations means that, if an exchange can’t hook its customers up with low-cost clearers, those customers will look for other trading venues that can.

Risk, too, will be a factor in how Europe’s post-trade world is structured. As Europe’s markets become not only broader but increasingly global in scope, exchanges will need to look more and more to their clearing infrastructure to shoulder risk. Allowing trading firms access to other clearing organisations, as the Code of Conduct mandates, distributes both market and operational risk across a broader base and, particularly where trades are netted across trading venues, simultaneously reduces the cost of risk mitigation.

Courtesy of MiFID, Europe is rapidly revamping and rebuilding its market structure in trading. It will be difficult to keep the urgency of this rebuilding effort from spilling over into the market infrastructure in clearing. Customers will want lower costs and better risk management. And regulators will want to see competition on the clearing infrastructure side comparable to what is happening in the markets themselves. The clearing infrastructure will need the speed, bandwidth and flexibility necessary to handle higher volumes and process more complex instruments. Renovation of the old wiring will no longer be voluntary. It will become a requirement.

But renovation is hard work. How much wiser to start the job now and install wiring that will keep Europe’s securities markets competitive in a global industry where investment ultimately flows to those markets with the greatest efficiency and liquidity.

Diana Chan is the chief executive officer, EuroCCP.