

# The vertical challenge

The past two months have seen the launch of clearing initiatives across five central and eastern European markets. What prospects do they offer for lower trading costs in the region?

Richard Schwartz

**T**alk to any broker who trades outside a single jurisdiction in Europe and chances are the high cost of post-trade services will be high on the list of complaints. MiFID might have facilitated trading venue competition, but securities services are far from integrated across the EU and post-trade market infrastructures are multiple and varied.

The initial promise of lower costs through horizontal integration has not met expectations. A decade or so ago, says Kevin Milne, director of post-trade services, the London Stock Exchange (LSE), “There was a real industry sense that horizontal integration was the way forward.” This resulted over time in mergers among exchanges (NYSE

/Euronext, NASDAQ/OMX, LSE/Borsa Italiana), clearing entities (LCH/Clearnet) and depositories (Euroclear and several national central securities depositories (CSDs)). “The feeling was that if you could get these integrated, it would push down the cost,” says Milne, “but the horizontal model has so far failed in its execution to realise the savings people had hoped for.”

At the same time, he says, the vertical silo approach may have brought efficiencies, but only

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within a closed environment where competitive pricing pressure is lacking. Part of the problem, he suggests, is that, “Trading models have evolved rapidly, but post trade has not. That creates friction points.”

### Squaring the circle

New initiatives in post-trade services, notably relating to central counterparty (CCP) clearing, would seem to indicate that markets are looking for something short of horizontal convergence, that nevertheless allows a degree of rationalisation at the operational level.

In early June, the Austrian capital market infrastructure provider OeKB announced the creation of a new solution, CCP.CEE – a standardised cross-regional clearing infrastructure for local central and eastern European (CEE) markets, beginning with the Austrian, Czech, Hungarian and



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Slovene exchanges that form the CEE Stock Exchange Group (CEESEG).

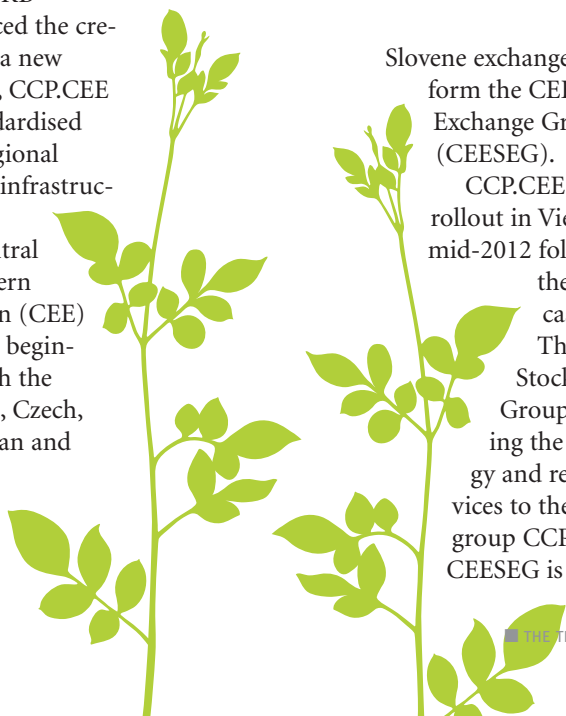
CCP.CEE will begin rollout in Vienna in mid-2012 followed by the Prague cash markets. The London Stock Exchange Group is providing the technology and related services to the new group CCP structure. CEESEG is already in

the process of implementing Deutsche Börse’s Xetra trading platform across all its venues.

Lower cost of access is expected to be an early benefit of the initiative, which will, however, leave the identity of each national market intact. “The combined approach could be particularly interesting for clients who are already members of one of the existing stock exchanges,” says Peter Peschek, director, head of direct securities services, Austria, at Deutsche Bank. “Most international brokers are already members of the Vienna Stock Exchange and should now be able to participate with less effort in the other markets, which should see improved liquidity.”

Hubertus Hecht is product manager, CCP.CEE, at OeKB. “Clients gave us a very clear indication that their main problem is the cost of entering these markets separately,” he says. “With their own technical interfaces, trading and post-trading arrangements, that cost was very high for the volumes of business they expected to do.”

Having one trading system and one CCP will lower the costs of entry. “The stock exchanges will



## Clearing & settlement



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remain,” he explains. “The market model is to have four stock exchanges, one trading platform, one CCP, four CSDs and four national banks for settlement.” Settlement will continue to take place locally, though integrated clearing will allow for some streamlining of collateral management. “We will calculate the margin and collateral requirements across all markets,” says Hecht. “Even if you are active across more than one of the markets, you will have one margin

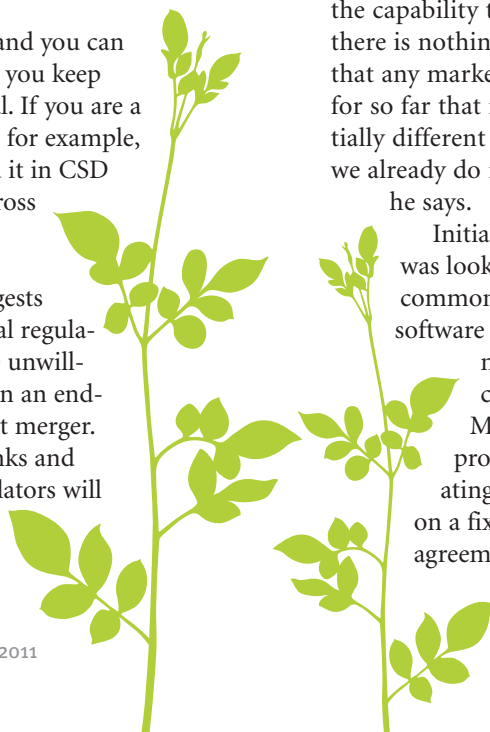
requirement and you can choose where you keep your collateral. If you are a Czech broker, for example, you may hold it in CSD Prague, or across two or more CSDs.”

Milne suggests that most local regulators would be unwilling to sanction an end-to-end market merger. “National banks and national regulators will always want to maintain a tight grip on

their national clearing process,” he argues. “It has to match their appetite for risk and is seen as part of the national financial system.” The model that the LSE is providing CEESEG allows for this. “The idea is to enable risk management, client relationships, local regulatory relationships and treasury management activities to be controlled at a local level, while outsourcing the less sensitive operational aspects,” he says.

In practice says Hecht, the local regulators have so far not indicated any substantial divergence or special requirements. “They may have certain reporting requirements that we have the capability to meet, but there is nothing special that any market has asked for so far that is substantially different from what we already do in Vienna,” he says.

Initially, the OeKB was looking to buy a common piece of software for the four national clearers, says Milne. “We proposed operating it for them on a fixed cost agreement. We’ve set it up as



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a model to sell to other markets.” Milne sees such opportunities arising in the medium term from a push to multi-asset class and real-time clearing, the platform for which requires significant investment to maintain.

### National focus

In the meantime, ambitions for further market integration in the region appear limited to the longer term. The first of July saw the live launch of KDPW\_CCP, the new Polish CCP, spun out of the KDPW depository, for clearing transactions executed in the regulated market – e.g. the Warsaw Stock Exchange – and across alternative trading systems.

As an interim step to the launch, KDPW Clearpool acted as a transaction settlement guarantor, backed by a €15 million guarantee fund, but did not act as a

principal to the transaction. “We needed to separate the risk management and collateral administration system from the depository in order to meet international standards,” says Iwona Sroka, president & CEO of KDPW and KDPW\_CCP. “But it is not simply a question of establishing a separate legal entity for clearing activities. In addition to new guarantee and cash netting functions, we will develop new services, including securities netting which we plan to introduce by the end of this year.”

Clearing and guarantee of OTC derivatives transactions, repos, reverse repos and market lending are also planned for the current strategic cycle.

The clearing house will use a risk management system based on Standard Portfolio Analysis of Risk, which calculates initial margins due to and from clearing members, according to the largest possible loss

incurred by a portfolio taking into account price and volatility. “We are implementing a risk management system based on well accepted standards,” says Sroka. “The technology is licensed from the Chicago Mercantile Exchange.” KDPW\_CCP will be able to use up to €25 million of its own capital to guarantee clearing liquidity.

Sroka sees expanded membership criteria of the clearing house as a particular attraction to foreign investors. “Direct membership of the CCP is not limited to local financial institutions,

but can include foreign entities that perform a clearing function, including investment firms,” she says.

While she acknowledges that there may be potential to offer clearing services to other securities markets in the region that currently lack a central clearing function, this is not currently a priority. The focus is more on improving the service to investors in Poland.

“Offering our services to other markets may form part of future strategy, but our priority is to attract more direct members to the Polish securities market,” Sroka says. “Poland is the biggest market in central and eastern Europe and our CCP is correspondingly the biggest in the region. Our priority is to ensure the quality of our new services to investors in Poland.”

Sroka is nevertheless open to interoperability with other markets. “We are interested in links to other CCPs, subject to agreed terms of cooperation and, of course, the assent of the regulators,” she says.

### Altogether when?

Quite how consolidation might play out at different levels of



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market infrastructure across the region remains to be determined. Any advances in this direction are likely to be cautious, however, given that the drivers may vary for each participant.

While CCPs explore the potential for interoperability, albeit somewhat gingerly, CSDs are also looking to reduce the operational burdens of settling cross-border transactions. Both the Link Up Markets model and

Euroclear initiatives continue. At a bilateral level, the latest initiative in central and eastern Europe, announced in late June, is an agreement between CSD Prague and the Slovak Central Securities Depository (CSD SR) to develop a technical link to facilitate the settlement of dual-listed securities.

“Consolidation in central and eastern Europe is a big topic,” Deutsche Bank’s Peschek admits. He sees potential for the expansion of CEESEG to more markets in the region. “The CEESEG model makes it easier for others to join without losing their identity,” he says. “If the four markets are successfully integrated from an operational perspective, it will be a good signal to others.”

At the same time, sensitivity to local considerations is likely to limit the attractiveness of grand plans for the meantime. Steps towards greater cooperation will continue, with clearing attracting particular attention owing to the high profile that risk management is receiving in the post-crisis climate, but competitive consolidation seems for now to be off the table. ■

