

Future of National CSDs in Europe



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Table of Contents

What is Centralised Clearing, Anyway?.....	2
And is Centralised Clearing always Good?.....	2
The Lesson to be Learned from Derivatives Markets.....	2
A Proposed Role for Domestic CSDs.....	3
Other Roles for Domestic CSDs.....	4
Small-Cap Markets.....	4
Operations of a New Securities Market.....	4
Software Services.....	5
Conclusion.....	5

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There seems to be an accepted wisdom in the European capital markets that there is no future for domestic¹ CSDs in Europe.

The gloom merchants' story goes like this: the whole market is being carved up between the powerful organisations that dominate securities clearing in continental Europe—the likes of Clearnet and Clearstream—and in due course every securities and derivatives transaction in Europe will be cleared through one of these entities. The fate of the domestic CSD is death at the hands of a silo—either to disappear down one of the verticals or be bulldozed by one of the horizontals as part of the process of ongoing consolidation. MegaClear, remotely headquartered in some major European financial capital, will eventually clear all the domestic transactions. The pressure on domestic exchanges is also cited as evidence that domestic capital markets are doomed. It is part of the received wisdom that national exchanges and CSDs share a common fate.

When everybody is saying exactly the same thing, it may be an indication that thoughtful analysis has given way to fatalism. We would argue that there is no inevitability to the notion that domestic CSDs are doomed, as with any branch of business (and let us not forget that clearing is a business). The question of survival and prosperity is dependent on how creative, adaptable and dynamic you can be—how useful you can make

¹ By “domestic,” we mean a CSD that only serves its home market and does very little or no business in securities outside its home market.



yourself to your customers and your stakeholders.

What is centralised clearing, anyway?

Before explaining why we think this is the case, let us revisit some of the assumptions that one often hears about securities clearing. First, we think that the merits of the case for a large central consolidated clearing structure are over-stated. It is commonly argued that a strong, central clearing organisation will deliver a more efficient market at a lower cost than competing clearing houses could—and that clearing is in any case a natural monopoly. We would argue that clearing is far from being a natural monopoly. It is certainly desirable that securities transactions for a given issue or symbol should be cleared together. This maximises efficiency of settlement, but this does not mean that a monopoly provider must deliver all the services associated with that process. Competition still has a role to play.

Essentially, it is untrue to say that all transactions for a given symbol should be cleared and settled in one place. Consider the case of a broker that has its own clearing firm, with clients buying and selling the same security during the course of the trading day. The clearing firm may well be a clearing participant in MegaClear, but in the accounts of the clearing agent (in a dematerialised environment), many of those client trades can be netted, cleared and even settled internally without any action on the part of MegaClear. In other words, Megaclear played no role in the clearing of those trades (other than perhaps to have been notified that the transaction occurred). Such transactions occur all the time. So clearing and settlement does not have to occur in the same place. In effect, centralised clearing is not a pre-requisite for an efficient clearing regime.

And is centralised clearing always a good thing?

Also, there is a fundamental risk-related drawback to having all the transactions concentrated in one place. Though most people consider it unlikely, a clearinghouse can fail. And if it does, which scenario is preferable—one small clearinghouse failing

every 30 years or one giant collapsing every 100 years? The consequences of one highly unusual large failure are much more serious than the consequences of a few sporadic small failures.

While this may be a theoretical argument and not one on which to base an entire strategy, it is a consideration, and in the context of a domestic CSD charged with the obligation to handle securities clearing for its domestic market, the idea of risk diversification is an important one. The survival of domestic CSDs helps to bring about risk diversification.

However, it is not our intention to suggest that central consolidated clearing will somehow never happen or is even undesirable. It may well be desirable if handled efficiently and without abuse of the monopoly power that it entails.

The important thing is to understand what role a domestic CSD can play in this new environment of powerful central clearing organisations. We think there a number of roles they can play, and we will look at them below, but the first and most important role will be the same as the one they already play—providing securities clearing and settlement services for their domestic market.

The lesson to be learned from derivatives markets

To illustrate how this role can continue, even in a structure where domestic securities are cleared and settled remotely by a MegaClear type organisation, we should look at the clearing model that evolved in the world's derivatives clearinghouses over the last 30 or 40 years. It is illuminating to look at derivatives clearing practices because they anticipate the way that clearing will eventually operate for all asset classes. The reason being that derivatives contracts were always dematerialised from the outset. There was never any notion of a physical depository.

Moreover, derivatives clearing has always involved the notion of a central counterparty (CCP). Dematerialisation and CCP are attributes that most CSDs either practice already or intend to adopt in the future. But they have been much slower getting there and



so the infrastructure of the average CSD is still less sophisticated than the average derivatives clearinghouse.

From an early stage, one of the standard attributes of the derivatives structure was the notion of a General Clearing Member—a clearing participant, who, in addition to clearing its own trades, was also authorised to become counterparty, through novation, to the transaction on behalf of brokers and traders who did not want to clear trades directly themselves. Such members were known as Non-clearing Members (NCM). The GCM inserted itself between the broker/trader and administered all the clearing and settlement processes on behalf of the NCM or its client. In a dematerialised, CCP environment this structure was easy to implement and operate. In the paper-based, non-CCP environment of the traditional CSD environment, the GCM concept was not used or only implemented half-heartedly, leaving inefficiencies in place.

A proposed role for domestic CSDs

The idea of the GCM is not something that only applies to the traditional clearinghouse infrastructure, whose population consists of the clearing organisation and the participants. There is no reason why it should not be applied at the country level, where a GCM represents a country. This is what we propose should be at the core of business planning for domestic CSDs. The CSDs should position themselves as service-oriented and profit-oriented, countrywide GCMs for the major clearinghouses of Europe.

The NCMs in this structure would be domestic brokers, banks, market makers and institutions, who are active in the local market and indeed active in overseas markets. The CSD becomes the country's primary gateway to clearing and settlement to the outside world.

Indeed this role need not be limited to just European clearing organisations. It could be adopted for CSDs throughout the world. There is no need to try to make the country GCM a monopoly through regulation—using regulation to gain a competitive short-term advantage is no way to build a sustainable

business. Instead, a well-run CSD will have its own competitive advantage derived from:

- its existing systems and service offering;
- its familiarity amongst domestic market practitioners; and
- its linkages to the payments system and other important components of the national capital markets infrastructure.

If a majority or even a substantial proportion of the CSD's regional business is executed through the countrywide GCM, then there remains an important clearing function for that CSD to provide.

The establishment of a country hub actually creates an opportunity for other value-added services, such as the provision of:

- back-office services;
- front-office gateways to international markets for domestic intermediaries;
- front-office gateways to domestic markets² for international intermediaries;
- investor information;
- custodial services;
- registrar services;
- local language services related to the local and international markets, but—to repeat—above all else;
- the continued provision of clearing services, by using the existing capabilities of a clearinghouse to process transactions, monitor risk, collect margin and execute all the other functions that are necessary for efficient clearing and settlement.

² However, this opportunity can only be exploited to the extent that the domestic economy supports and operates its own marketplace. A second concern of smaller economies is that they will lose their ability to operate an independent exchange, as well as the clearing operation.



Even in the face of international consolidation, the local CSD is in a powerful position due to its knowledge and skills. After the clearing of domestic securities has migrated to a more central consolidated clearing organisation, there remains much added value that a local provider can offer. Essentially the CSD will have transformed itself into a clearing services provider for the local market.

The best way to do this is for the CSD to evolve into a for-profit model. For this reason, it may be appropriate to form a JV with some of the international providers of general clearing services such as Pershing, Fortis, KAS and ING. These firms have in-depth technical expertise in operating clearing services at the intermediaries level and in dealing with foreign capital markets operators. That experience would be invaluable in helping the CSD move into a new phase of value-added clearing and settlement services.

The essence of the strategy is this: accept the migration of central clearing to international clearing centres and swap 100% of a small market for a small percentage of a huge market, with the result that a much wider array of options is presented to the business. (Note that this idea is not new. Similar arrangements have been put in place linking markets around the world. Most notably between Canada and the U.S., Germany and the U.S.; and between Singapore and Australia. The novel aspect is to convert the traditional CSD operation from a utility to a focused, value-adding **enterprise**).

OTHER ROLES FOR DOMESTIC CSDs

Small-cap markets

In our view, local securities market will continue to exist and in some cases flourish, even in the face of international consolidation. As long as there is domestic capital, there will be domestic consumers of that capital. There is always a constituency of investors who will invest in the local market. Only if capitalism itself has failed will local capital not seek local investments. However, given the relative lack of appeal that such securities would have for international investors, this is a natural niche for the domestic market. A small-cap market

could be developed under the auspices of the CSD, which would of course provide clearing and settlement services. Indeed, the CSD could be more ambitious than that.

Operation of a new securities market

Domestic exchanges are under similar pressures to those faced by domestic CSDs, but the relative competitive positions are dramatically different. Exchanges have historically focused their resources on creating automated auction systems that mimicked the systems of large exchanges. These investments in technology have satisfied the egos of exchange executives but they have not actually answered the problems of enhancing liquidity in thinly traded products, which tend to make up most of the listings in domestic markets.

The domestic CSD is already in a position of some competitive advantage compared to the domestic exchange, given that it clears all or most of the securities transactions in a marketplace. This suggests that it could plausibly operate as an exchange as well since it already has the community of securities practitioners as its customers. By constructing a new market using state-of-the-art, liquidity promoting technology³, rather than the old, limit-order based architecture of today's legacy trading systems, the opportunity may exist to create a powerful, new central securities marketplace in competition with domestic exchanges that are tied to that old technology. Caught between pressure from senior markets that are seeking new listings, and the CSD that is offering pre-trade services for all the other listed symbols, the exchange may see its core business taken away.

With this architecture in place, the CSD would be in a position to pursue OTC business as well as creating the right setting for building a derivatives market if one is not already in place. Moreover, the concept of central counterparty clearing is taking hold outside the securities industry. B2B business continues to grow, albeit in a somewhat different form from what was initially anticipated and the idea of novating trades

³ See AMSL's white paper *Liquidity Networks*.



between counterparties so as to reduce counterparty risk will have increasing appeal. There will inevitably be local markets that are not easily assailed by foreign operators, where the CSD can offer such a clearing service. This can be part of a complete service that includes a trading platform as described above or it can accept trades from other B2B or OTC exchanges.

Software and services

Finally (or maybe not finally—after all, other ideas may emerge once the domestic CSD believes that its fate is not to “roll over and die”), there is the possibility of using the CSD’s in-house expertise to provide software tools and services to local intermediaries, particularly in the area of back-office systems. An extension of this idea would be to offer business, consulting, and software services to other central capital market organisations in smaller, growing markets. All over the world, there is a demand for solutions to the challenges faced by smaller domestic capital markets. A CSD that has faced up to daunting international competition, and has already addressed those challenges from within a smaller market will have some valuable advice, and maybe products, to offer other markets.

Conclusion

The domestic CSD can survive and even prosper in this new era of competitive trading and clearing. What it requires is an entrepreneurial approach to the challenges it faces.

It is up to the CSDs themselves to leverage their expertise and market position to exploit change and create a competitive, profitable business model from the in-built advantages they already possess. This means re-thinking their roles in the capital markets.