



European securities infrastructures have shown no signs of weakness during the recent episodes of the crisis². But evolutions are required to improve the efficiency and safety of EU securities markets in the context of the on-going changes in securities markets and EU regulation.

The possible impact of efficiency measures on the risks associated with securities post-trading activities should be taken into consideration. EU authorities should also favour a more systematic implementation of central reporting processes and possibly Central Counterparty clearing (CCPs) in order to reduce the operational and credit risks of on-exchange and OTC markets. Finally EU securities regulation and in particular the MIFID Directive should be implemented in a more consistent way across markets (on exchange, OTC) and venues (stock exchanges and alternative venues) to encourage more transparency and efficiency.

1. The potential impact of the efficiency measures targeting EU post-trading infrastructures should be reviewed from a risk management perspective:

European post-trading securities infrastructures have shown no signs of weakness, such as losses due to credit or operational problems, during the recent episodes of the crisis, including the bankruptcy of Lehman Brothers. However, European authorities should ensure in relationship with the industry that the changes currently taking place in this sector and the focus on achieving greater efficiency are not reducing the capacity of these infrastructures to manage risks correctly and generate economies of scale in the longer run. Authorities should also ensure that competition in the sector will not reduce the infrastructures' investments in risk management as a result of the pressure to cut costs and attract more business, that standards are regularly reviewed with the users of these infrastructures, and that competing entities are not supervised in a disharmonised manner.

Indeed, these infrastructures have seen many changes over the last few years that are progressively coming to a head. They have been demutualised with a view to developing their profitability and making it easier for them to be merged. However, their consolidation and the economies of scale achieved have remained partial at the European level. Models for vertical integration, horizontal consolidation within Europe and on a transatlantic basis have developed both in the trading and post-trading sectors.

In order to accelerate the reduction in prices of post-trade services, the Commission has encouraged these infrastructures to be put into competition with one another through the Code of Conduct, notably encouraging the infrastructures to interconnect, rather than imposing more structural reforms. The transparency requirements of the Code are considered to have facilitated price reductions for cash equities particularly for clearing services. However, the potential consequences on risk management of developing competition have not yet been assessed in detail. Indeed, the interconnection of clearing infrastructures may potentially create new risks – eg introducing new financial and operational risk exposures between CCPs³, perpetuating or possibly increasing the fragmentation of positions in Europe⁴ and introducing possible legal risks by connecting infrastructures operating under different rules and jurisdictions

Furthermore, putting players such as CCPs and CSDs that are now mostly "for profit organizations" into competition with one another could encourage them to attract users through lower risk management standards – to reduce costs - if the other possible areas for differentiation seem insufficient. Preventing this could become more complex for regulators faced in parallel with a greater number of infrastructures in Europe - eg a greater number of CCPs – and infrastructures operating in different ways. Indeed, MIFID by opening up competition in the trading space has encouraged the creation of new clearing service providers to give market participants a wider choice in where to clear and with the objective to reduce clearing and settlement costs. These new providers typically cover multiple markets, are used mainly by MTFs (Multilateral Trading Facilities) and may operate with different practices, business and governance models from those of incumbent and typically national securities infrastructures.

Recommendations were published in October 2008 by ESCB-CESR to increase the safety, soundness and efficiency of securities clearing and settlement systems and CCPs, respectively. But these recommendations are not mandatory and are still relatively general in their definition. Once finalised, they should be used as a regulatory tool by regulators and overseers. A strict monitoring process of the implementation of these recommendations involving the different stakeholders should also be encouraged at an EU level.

¹ This Eurofi paper do not engage the Chairmen of Eurofi

² They have continued performing their essential functions during the crisis without incurring losses themselves due to credit or operational problems

³ That are of critical importance to the markets they serve

⁴ Some observers point out that the fragmentation on the clearing side may not necessarily lead to a risk of fragmentation of collateral and a need for participants to put up collateral at several clearing service providers. They indeed consider that competition could lead to product specialization in the clearing space which could in turn reduce the fragmentation risks

2. EU authorities should favour a more systematic implementation of clearing processes and possibly Central Counterparties (CCPs) in order to reduce the risks of on-exchange and OTC markets.

As highlighted by the current financial crisis it is crucial to improve the control of the systemic risk in all markets and particularly OTC ones, such as derivative markets and part of the fixed income market. The financial crisis, particularly following Lehman's bankruptcy, has led to greater concerns over counterparty risks in OTC markets in particular – and for Credit Default Swaps (CDSs) for example. Counterparty risk for these products could be overseen or mitigated by market infrastructures in several ways⁵.

- Market infrastructures can provide regulators with transparency on the positions held by trading firms through mandatory transaction reporting. Such reporting necessitates a minimum standardisation of data and thereby aids regulatory supervision of traded positions. This is usually performed for on-exchange instruments by CCPs but can also be handled by a data warehouse.
- Centralisation and tabulation of transaction details and obligations ("clearing") makes it possible to lower risks and costs by facilitating multilateral netting, a numerical exercise that significantly reduces risks by minimising the number of transactions and related money amounts that need to be settled. This activity is usually performed by CCPs.
- The legal novation of obligations to a central counterparty (CCP)⁶, to mitigate the replacement cost risk⁷ can also be achieved. However, certain observers point out that for a CCP to properly manage risks and provide genuine safety for users and regulators, there must be a reliable market price for the asset transacted in order that the CCP can calculate the margin it needs⁸, as well as sufficient liquidity in the asset⁹, or hedging available at a reasonable cost. This could be provided by a minimum level of standardization of the main characteristics of the products¹⁰. Other market players add that a proposal for a possible European CCP for OTC CDSs should not be rushed without analysing the repercussion that it may have on the functioning of the markets. They believe stakeholders should first agree on its main features and specific users requirements

⁵ This does not mean moving the OTC market on-exchange, although further improvements could also be expected by moving the sub-set of truly standardized OTC products on-exchange – ie further trade and product transparency, better quality checks - .

⁶ Providing a guarantee to each party in a transaction that the price agreed will be honoured even if the other party goes bankrupt before the trade is settled

⁷ I.e. the risk that a trading party goes bankrupt during the interval between the execution and settlement of a trade, and the price of the asset moving unfavourably against the surviving party which has to replace the trade

⁸ From the parties whose obligations it is taking on

⁹ So the CCP can replace a trade with the minimum delay

¹⁰ Some observers point out that an excessive level of standardization could cause market liquidity to become concentrated in a much smaller number of standardized derivative products than are currently traded OTC. This could increase the difficulty and cost of hedging some transactions.

There is also an on-going debate around the location and perimeter of possible EU CCPs for these instruments. These issues are currently being reviewed by market representatives and international and EU representatives (Commission, ECB...) but in any event greater transparency through a multilateral netting facility should be set up as soon as possible in priority for CDSs.

Some players also stress that it is important to ensure market integrity and surveillance in OTC markets, since there is a risk of OTC markets being potentially favoured by the greater difficulty to ensure controls in such markets.

3. A regulatory level playing field should be maintained between stock exchanges and alternative trading venues

Putting players into competition with one another also represents the Commission's preferred course of action in the trading space through the implementation of the MiFID Directive, which has encouraged the emergence of alternative trading venues: Systematic Internalizers (SIs) and Multilateral Trading Facilities (MTFs). These alternative trading platforms saw a major boom in 2008, resulting in a drop in prices among incumbent operators¹¹. However, several areas still need to be clarified according to comments received by some market players:

- A level playing field should be maintained between regulated markets and alternative execution venues in the way rules are enforced. Possible differences in supervision between regulated markets and MTFs have indeed been highlighted by some players in areas such as system security and transparency requirements.
- A revision of the definitions of SIs and MTFs and of the transparency requirements of the SI system appear to be necessary for some observers in order to improve transparency on the publication of pre-trade prices by entities executing orders. Indeed, certain business models that do not come under the definition of Systematic Internalizer or MTF may not be taken into the scope of MiFID. In addition, some consider that the transparency required under the SI system could be improved (e.g. "transparency" can be a quote on only one side and for one share).
- Another issue to be clarified is whether fragmentation of trading and of liquidity in European equities markets impacts negatively on price formation

¹¹ Some observers consider that the emergence of MTFs has led to significant reductions in trading executions costs for investors executing on some, but not all, of Europe's major trading venues and improvements in product services. They also believe that this has resulted in increased liquidity permitting European investors the ability to execute large orders with minimal impact on market prices.