

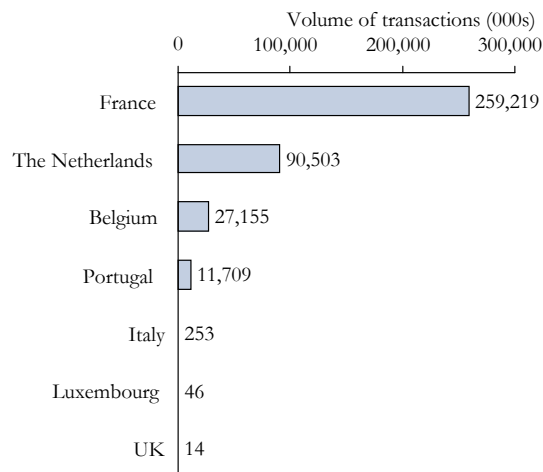
How to Survive the CCP Revolution

The announcement that NYSE Euronext intend to build their own central counterparty (CCP) would have sent shock waves around the industry had it not coincided with the Greek debt crisis, the plunging markets, the UK election, etc. Nevertheless it is one of the most significant developments in securities infrastructure in the last five years. As regular visitors to Cairneagle.com will already know, over the last three years, we have been strong advocates of an increased role for CCPs:

“Many operators of trading facilities (exchanges, MTFs, etc) are beginning to realise that without a partner CCP their ability to innovate in trading markets by bringing in new instruments like OTC derivatives, credit or energy, is very limited. We therefore expect that the trend for separation between CCPs and Exchanges is likely to be reversed, with exchanges and other market operations seeking to own or partner with CCPs.” (J. Hine, www.cairneagle.com, 2008)

Clearly the impact of the announcement has been most keenly felt at LCH.Clearnet SA. Clearnet was established to clear the French market and naturally gravitated to clearing the consolidated Euronext market; its revenues were €179M in 2009. The Clearnet systems have been widely praised and it must have felt that its position as clearer for the consolidated NYSE Euronext business (both its main markets and its MTF off-shoots like Smartpool) was secure. Even when the LIFFE market took control of its own clearing arrangements, that was seen as a wholly UK issue, separate from the main relationship with NYSE Euronext. Indeed the board of LCH.Clearnet may now rue their rebuttal of the merger overtures from DTC. So what has prompted NYSE Euronext to instigate such a major shift in strategy?

LCH. Clearnet SA number of cash (outright) securities cleared in 2008



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On the surface the move into clearing seems strange as the USA experience of NYSE has demonstrated how well an exchange and an independent CCP (DTCC) can work in harmony for the good of the industry. The fact that, unlike DTC/DTCC, LCH.Clearnet is a ‘for profit entity’, as will be the new NYSE Euronext CCP, is clearly an important factor. However the revenue figures mentioned in the NYSE Euronext announcement may be difficult to reach in the short run while the market is pressing for greater cuts in post-trade costs. Even if they were to turn out correct, taking such a strategic move simply to develop a new revenue line in a wholly new sector would be an unusual step in the exchange

business. In fact there are three additional factors which make the acquisition of a CCP business a clear strategic win for NYSE Euronext:

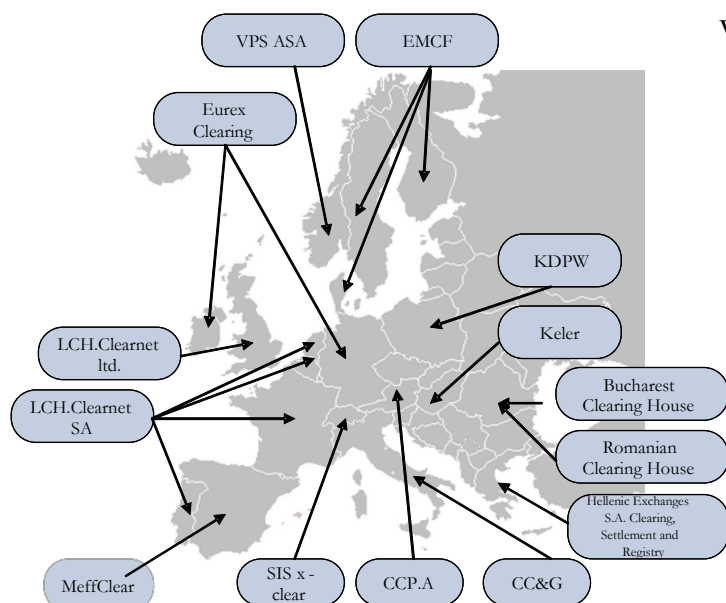
1. Firstly, there is the reason we have already alluded to in several articles since 2008: an exchange without a CCP is constrained in its product development. The ability to create new products and to transfer existing OTC products to exchange platforms is wholly dependent upon the CCPs' willingness to cooperate – and the CCPs have shown themselves slow to rise to this challenge.
2. Secondly, the exchanges (including NYSE Euronext) are under immense pressure from lower cost competitors. In as much as post trade services constitute a major part of all-up trading costs, controlling a CCP makes good commercial sense; it may not generate super-profits but it may allow you to retain your price sensitive customer base.
3. Thirdly, we should understand that the systems and structures of the existing CCPs are getting pretty old. In most cases they were developed for single market clearing with single settlement links at the back end. They were often single currency, they lacked sophisticated collateral management structures and had limited accounting services for the many securities clearing banks which used them. In a world of multi-market, multi-instrument clearing with linkage and cross margining as major industry issues, some CCP systems have become 'business prevention' machines rather than assets. So the 'build rather than buy' approach of NYSE Euronext may make sound commercial sense. Indeed the down-grading of NYSE Euronext from AA to AA- by S&P following their CCP announcement appears to be one of the more inexplicable credit decisions of the last few years (and that is saying a lot!).

The effect of the NYSE Euronext move will be felt by other European exchanges, MTFs and CCPs. It will also call into question the whole concept of linkage and regulation of the post trade market – but let us leave that fascinating can of worms for another day! The effect on exchanges which compete directly with NYSE Euronext (and here we look primarily at the London Stock Exchange) is clear – they have little option but to establish their own CCP. Indeed that particular penny dropped some time ago at the LSE, as the negotiations to acquire the European Multilateral Clearing Facility NV (EMCF) have demonstrated. The inability to close this deal is clearly a concern for LSE supporters, but it should be noted that EMCF is by no means the only game in town. The LSE may consider an approach to LCH.Clearnet Ltd – the UK arm of the LCH. Clearnet group, which has never been fully integrated with LCH.Clearnet SA; or it may indeed make an approach to the whole LCH.Clearnet group. Alternatively it too has the 'build' alternative taken by NYSE Euronext. In any case the pressure must be on to come up with a solution for clearing, whether through acquisition, building or a partnership arrangement. For the smaller exchanges and MTFs, the fear must be that without the business of large exchanges like NYSE Euronext, the economics of the CCPs which serve them will simply not work. Thus a Clearnet dependent solely upon revenue from independent MTFs (dark pools, crossing engines etc) might be forced to increase prices to these smaller entities which would wipe out the commercial advantages of using dark pools and other alternative trading venues.

There are currently over 20 CCPs in Europe. Some have a happy little niche in their local markets, while others have aspirations to become product specialists across markets or regional players through linkage. The announcement of the new CCP must be a shock for them all and now is the time to begin considering their options. However even before doing that, a realistic assessment of the systems, economics and customer relationships of each CCP seems to be imperative. Large CCPs, with multi-market and multi-product clearing facilities, offer economies for the large players in the financial markets, particularly for the securities clearing banks which consolidate the business of the smaller firms. Offsetting margin, high volume fee reductions, single rule set and simpler communications will all play a part in attracting business to the larger CCPs. Indeed we have already seen some very large banks make it clear that wherever possible they intend to concentrate their business with a single CCP. Smaller CCPs

may feel that their product or location specialisation may buy them time, and they might believe that they will be protected by EU regulations, but this strategy may be no more than a holding operation. The tide is coming in and it may sweep some of them away.

Major European CCPs for Exchanges ¹



Major European CCP transaction volumes ²

Venues Cleared	Volume of transactions (M)
6	Eurex Clearing 2,300
2	NYSE Liffe Clearing 1,056
13	LCH.Clearnet Ltd 955
7	EMCF 852
9	LCH.Clearnet SA 644
6	CC&G 103
5	EuroCCP 101
1	Meff 93
5	SIS x-clear 33
3	MeffClear NA

1. Excludes European Commodity Clearing AG, ICE Clear Europe, Nasdaq, OMX Stockholm AB, also pan-European EuroCCP

2. Includes transactions on MTFs and darkpools
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Many smaller CCPs may now consider amalgamation into linked groups as a strategy for survival. In a world where ‘silo markets’ (with integrated trading, clearing and settlement) seem likely to appear in Frankfurt, London and Paris, the creation of one or two independent CCPs with Europe-wide reach would seem to be a sound strategy for the industry and for the CCPs themselves. While issues like linkage, communications, law, etc. are by no means trivial, such a future may be the only way to avoid an exchange-led oligarchy of Central Counterparty Clearing in Europe.

If you wish to discuss any of the issues in this paper, please contact Rupert Barclay or Joseph Hine at Cairneagle Associates on 02070363401.

Appendix A. CCP Venues Cleared

CCP	Venues cleared
EurexClearing	Eurex, Eurex Bonds, Eurex Repo, European Energy Exchange, Frankfurt Stock Exchange, Irish Stock Exchange
NYSE LIFFE Clearing	NYSE Liffe, Bclear
LCH.Clearnet Ltd	LSE, Six Swiss Exchange, LME, Equiduct, OTC Emissions, EDX, Nodal Exchange, OC Freight, BATS, PLUS, Turquoise, NYSE Arca, ChiX
EMCF	Nasdaq, OMX, Chi-x, BATS, PLUS, Burgundy, Quote MTF, TOM
LCH.Clearnet SA	NYSE Euronext, Smartpool, Equiduct, Fixed Income Markets, MTS Italy Markets, Bourse de Luxembourg, Bluenext Futures, Secfinex, OTC
CC&G	Borsa Italiana, Borsa Italiana MTF, IDEM, IDEX, Euro MTC, Broker Tec
EuroCCP	Turquoise, Pipeline, Smartpool, Equiduct, NYSE Arca Europe
Meff	MEFF
SIS x-clear	Six Swiss Exchange, LSE, Equiduct, Smartpool, Liquidnet
MeffClear	SENAF, AIAF, OTC