

Clearing the hurdles

Lynn Strongin Dodds talks to Ted Myerson, senior vice president, Access Services and FTEN for NASDAQ OMX's Transaction Services business about the European clearing landscape

There are two themes running alongside each other in European clearing - interoperability and the OTC rules. How do they relate to the intra-day credit control topic?

The ability to control credit on an intra-day basis across markets is linked to both interoperability and regulation tied to OTC derivatives. From the interoperability side, we see central counterparties (CCPs) taking a more active role in trying to solve the number of problems facing general clearing members (GCMs) from a real-time risk management perspective. On the regulatory side, there is the efficient capital deployment and distribution challenge and that has not been addressed.

There has been a lot of talk on the interoperability front but so far not as much action as expected. Do you think progress will continue to be made?

Definitely. The train has left the station and there is no going back. Although we still have the integrated model, we start to see the beginnings of CCP consolidation and that will continue. I don't think though that Europe will only have one CCP like the US but instead three or four. It will take time though.

Which regulation is having the most impact on credit control and management in clearing?

Dodd-Frank, EMIR, Basel III and MiFID II. The first two are driving the shift from OTC to centrally cleared trading and require higher levels of collateral and margin requirements. This means more

money will be needed to cover derivatives transactions. Under Basel III banks and GCMs will need to lock away more capital while MiFID II calls for greater transparency and more "adequate" risk management for brokers, trading mem-

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bers and GCMs. In addition, industry associations are increasingly highlighting the importance of clearing certainty as an important means to reduce systemic risk. This further drives the needs for real-time, pre- and at-trade risk management infrastructure in the clearing space.

What are the main challenges facing GCMs?

GCMs are operating in a highly competitive clearing environment which is also being impacted by low trading volumes across Europe. What we have seen is that

smaller GCMs such as KBC Clearing and Penson Europe are exiting the business while the larger players are launching new initiatives to further grow. In order to stay competitive they will need to enhance their offerings to reach a wider audience and deliver more services.

What will they need to change?

The need for intra-day risk management combined with complex market conditions and the heightened regulatory environment are affecting GCM risk management processes and procedures in a number of ways. For example, they will need effective capital management practices in order to protect and safeguard available capital for intelligent allocation. Growing their business will also mean diversifying their service offerings to attract new clients as well as tighter risk controls to manage the increased volume and potential exposure.

Overall, GCMs need better monitoring of clients across markets and CCPs in true real-time as well as greater control over trading to mitigate excessive risk taking. Their risk management infrastructure needs to be faster in order to better protect their business as well as effectively compete, expand their client base and comply with pending regulation.

How prepared are they?

Currently, GCMs have little control over intra-day credit consumption by the clients. They typically extend credit on an overnight basis and they are fairly blind to the intra-day trading activities of non clearing member (NCM) clients. They are

dependent on the data they receive from the CCPs, which is often in the form of a delayed trade feed. As a result, they are the last in the chain to receive position information from their clients. CCPs have recently started to launch real-time position feeds but the data provided generally relates to novated executed trades only. No information is provided on open order exposure, which would enable the GCM to understand the worst case scenario of the exposure in real-time.

GCMs often have inadequate risk management infrastructure to aggregate and manage risk across markets and CCPs on a real-time basis. They can't monitor or limit intra-day credit consumption of their clients. Traditional risk management infrastructure in the clearing world has been focused on end-of-day or batch processes and very few firms have the ability to set intra-day position limits on their client's trading activities across all markets and CCPs.

GCMs have also only limited means to stop or mitigate excessive risk taking of NCM clients in a timely manner. If there is a problem and subsequently a default, the GCM is entirely responsible for all incurred losses minus the amount covered by the margin collected, which is based on yesterday's or past trading activities.

What are the solutions on offer?

Some market participants are discussing a setup, whereby most of the intra-day risk management and control functions are pushed onto the CCPs. Although the CCPs will increasingly be part of a very important real-time risk management function for GCMs, they are not in a position to provide them with a comprehensive risk profile of their end clients across multiple CCPs. Currently non-vertically integrated CCPs may find it difficult to deploy "kill switch" (also often referred to as automated trading halts or automated suspension) functionality across all the markets in which a GCM operates. Additionally, most CCPs do not have direct relationships with the GCMs' end clients and therefore are not in a position to enforce a trading halt unless instructed by the GCM.

There is also a GCM-centric real time

solution across multiple CCPs. As discussed, interoperability will help consolidate the positions of different NCMs and GCMs in more centralised places, market dynamics, vertical silos, and relationships. This will lead to the use of a select few CCPs across all trading venues and as a result, GCMs will need to aggregate their NCM client positions across these CCPs and disparate trading platforms to truly understand the exposure to the firm.

In addition, this aggregation needs to occur in real-time to monitor for excessive risk taking in a timely manner. In order to achieve this, a solution needs to aggregate real-time feeds from all CCPs or trading platforms to provide the GCM with the appropriate information. In line with this requirement, more and more CCPs are launching real-time position and even margining feeds.

Last but not least is the kill switch mechanism which would allow a GCM to automatically suspend a client from trading in the event of an intra-day breach. GCMs should be able to deploy their own "kill switch" devices in to the NCM trading flow or utilise flow control mechanisms provided by third parties or other market structure participants to better actively mitigate risk taking.

Their risk management infrastructure needs the ability to connect with third party trading, matching, and clearing infrastructures to programmatically activate the distributed "kill switches" across all the different trading venues where the end client is trading. This requires a flexible and open signalling API to interface to a variety of different systems. Ideally, over time, a common risk communication protocol and kill switch triggers should evolve in the industry.

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