

## Interoperability: Is it worth the effort?

EuroCCP's CEO **Diana Chan** says two key provisions are needed to deliver the benefits of interoperability between central counterparties



by Diana Chan

Everyone who carries an ATM card is a beneficiary of interoperability. Without interoperability among banks, consumers would only be able to withdraw cash at an ATM installed by their own bank. The same with mobile phones – if telephone networks don't interoperate, consumers would only be able to call others using the same network.

Investors in the equities markets are less fortunate. Although the same stock can be traded on different trading venues (i.e. stock exchanges and multilateral trading facilities), there is still no material interoperability among the central counterparties that guarantee these trades. Firms can trade where they choose but are obliged to use the CCP each trading venue has appointed. This arrangement means limited competition among CCPs and also more complexity. Typically, a different CCP was introduced by each trading venue and this has led to the current fragmentation. The number of CCPs could still grow with new, stock exchange-specific CCPs being created. Firms that trade on different venues are obliged to connect to multiple CCPs, incurring higher cost and higher operational risks. Being required to use multiple CCPs is like having to open an account at every bank and carrying multiple ATM cards in order to have the convenience of using any ATM machine.

Interoperability is simple enough as a concept: it requires competitors to cooperate in order to provide choice and more efficient services to consumers, while still competing on quality and price.

Just like competing telephone networks have delivered better and cheaper services to consumers and led to many more cross-border telephone calls being made now than 20 years ago, interoperability and effective competition among CCPs in the equities market could have a big and positive impact on the capital market.

Solving interoperability among CCPs could have the effect of multiplying the trading volumes across Europe by lowering the cost of clearing, creating more liquidity, investment activity and employment.

Interoperability among CCPs has been difficult to achieve for a number of reasons, one being the lack of a clear public policy. It took legislation in the form of Mifid to open up stock exchanges to competition whereas no equivalent legislation exists to open up CCPs to competition. In 2006, exchanges and CCPs signed a voluntary Code of Conduct that was intended to introduce competition among CCPs without requiring legislation. Four years later, it has become obvious to many who want to see competition flourish among CCPs that legislation is required to remove the commercial barriers to interoperability.

Two key provisions are needed in legislation to deliver the benefits of interoperability. First, trading venues must be obliged to give non-discriminatory access to CCPs that want to clear the trades for their customers. Trading venues match buyers with sellers and are at the source of the trades. CCPs are downstream service providers and need access to the trades in order to clear them. Since it is trading firms, not trading venues, that pay the CCPs to guarantee the trades, it seems reasonable that the choice of CCP should reside with the trading firms. Second, CCPs that already clear the trades originating from a venue must be obliged to interoperate with competitors who also want to clear for the same venue. If left to individual decision, incumbent CCPs will most likely interoperate only with those who are least able to challenge their dominance and hence less desirable to most users, effectively maintaining the status quo.

The safe and efficient organisation of CCPs is an important issue because of the post-financial crisis global policy of encouraging more assets and more transactions to be cleared via CCPs. CCPs' centralised risk management has demonstrated its value during

the financial crisis. The equities markets already have the characteristics that make interoperability among CCPs technically feasible, and there is significant user demand for more competition and less complexity in this sector. There is still work to do to ensure that interoperability is also safe and scalable, both to the volume of trades and to the number of inter-operating CCPs. Once the pipes are unblocked by interoperability, friction will be removed from cross-border trading in the EU, investment will flow freely, liquidity will increase, and trading volumes will grow to benefit the size of the European economy. Issuers and investors will ultimately benefit from interoperability.

### What is a CCP?

A CCP (central counterparty) is a company that provides the guarantee to both the buyer and seller in a trade that if one party defaulted, the CCP would fulfil the financial obligations to the remaining party as agreed at the time of the trade. A CCP mitigates replacement cost risk or market risk i.e. the risk that the remaining party has to replace the trade at an unfavourable price.

A CCP adds the most value when there is a high counterparty risk and when there is a high market risk, such as the possibility that the price would have moved unfavourably when a trade has to be replaced.

### How does interoperability between CCPs work?

Interoperability between CCPs is an arrangement whereby each CCP, representing one party to the same trade, ensures that it does not suffer a loss due to the other CCP's default and that it remains capable of meeting the obligations to its own customer. When firms are free to choose CCPs, two trading parties might have selected a different CCP. Each CCP provides the guarantee to its own customer. If one CCP defaults, the remaining CCP would still need to make good the trade to its own customer.