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Clearing in the Savings and Investments Union

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Abstract

Equities clearing and settlement in the EU are mentioned in recent reports as important areas for reform to support the Savings and Investments Union. Reports differ on the proposed way forward, with the Draghi report being the most outspoken in suggesting a move to a single CCP and CSD. This note argues that EU public policy over the last 25 years has only been partly successful in making clearing more efficient and competitive. Clearing fees substantially decreased but complexity and the total number of CCPs have not. The need to access many different CCPs comes with substantial costs. The current momentum creates new possibilities for much-needed change. EU public policy should increase its focus on removing barriers to further collaboration and alliances and on EU competitiveness with other jurisdictions. Private sector leadership is essential for a market led solution towards alliances and lower cost, while taking into account the heterogeneous nature of EU financial markets.

Note: This brief was earlier presented as a keynote speech at the risk summit of the European Association of Clearing Houses.

Introduction

The topic of clearing and central counterparties (CCPs) has again made its way into the limelight, this time in the context of the Savings and Investments Union (SIU).

On 17 September, the President of the European Commission, Ursula von der Leyen, published her mission letter to Maria Luis Albuquerque, as Commissioner-designate for Financial Services and the Savings and Investments Union. The mission entails, among other points, to develop the European Savings and Investments Union, including the competitiveness of the financial sector. The Commissioner has to explore further measures to increase the availability of venture capital and other risk capital, and - here it comes -, remove barriers to the consolidation of stock exchanges and post-trading infrastructures.[1]

This mandate follows the publication of various reports during the last few months on the Capital Markets Union.

The Draghi Report, for example, states that an important step towards the integration of the security market in the EU would be to create a single central counterparty platform and a single central securities depository (CSD) for all security trades.[2] The Letta Report suggests focusing on the integration of clearing and settlement, and states that 'judging by the US experience, where stock exchange competition is strong, it seems that there is no apparent need for competition in the clearing and settlement markets, as long as there is fair and open access for all actors, proper governance and sufficient incentives for innovation.' [3]

Consolidation and competition of post-trade infrastructures are complex issues that have been discussed for more than 20 years. In this note, I would like to unpack these concepts, while also taking into account historical developments. I focus on CCPs, however, many elements are relevant for the securities settlement space as well. The aim is to help move the debate forward. In line with ESMA's position paper on building more effective and attractive capitals in the EU published in May, I call for further addressing barriers to the integration of market infrastructures through collaboration and alliances.[4]

The issue

There is an urgency brought forward in the different reports that is compelling. If the EU doesn't move course, its future as an economic power is at stake. The Noyer report puts it as follows: 'companies, including small caps may consider turning to the United States for fundraising. This trend poses risks to European strategic autonomy'.[5] Hence, developing the SIU calls for the highest priority.[6]

To make the SIU a success, addressing inefficiencies in clearing and settlement arrangements is key. Indeed, the post-trade infrastructure is just one of the many areas in which action is needed, and reforms in this area alone won't do the job. Nevertheless, post-trade infrastructures are a cornerstone of the financial system and play a large role in the efficiency and reliability of investment activities. Inefficiencies in this infrastructure weaken the ability and willingness

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[1] https://commission.europa.eu/document/download/ac06a896-2645-4857-9958-467d2ce6f221_en?filename=Mission%20letter%20-%20ALBUQUERQUE.pdf.

[2] The future of European competitiveness – In-depth analysis and recommendations, September 2024, https://commission.europa.eu/topics/strengthening-european-competitiveness/eu-competitiveness-looking-ahead_en#paragraph_47059 .

[3] Much more than a market – Speed, Security, Solidarity; Empowering the Single Market to deliver a sustainable future and prosperity for all EU Citizens, April 2024, https://www.consilium.europa.eu/media/ny3j24sm/much-more-than-a-market-report-by-enrico-letta.pdf .

[4] Building more effective and attractive capital market in the EU, ESMA Position Paper, May 2024, https://www.esma.europa.eu/sites/default/files/2024-05/ESMA24-450544452-2130_Position_paper_Building_more_effective_and_attractive_capital_markets_in_the_EU.pdf .

[5] Developing European capital markets to finance the future, Rédigé par DG Trésor • Publié le 25 avril 2024, https://www.tresor.economie.gouv.fr/Articles/2024/04/25/developing-european-capital-markets-to-finance-the-future.

[6] See also the statement of the Eurogroup on the future of the Capital Markets Union. https://www.consilium.europa.eu/nl/press/press-releases/2024/03/11/statement-of-the-eurogroup-in-inclusive-format-on-the-future-of-capital-markets-union/.

of market participants to engage in equities trading in the EU, they decrease liquidity in financial markets, and raise the cost of capital.

The various reports all mention the numerous post-trading infrastructures in the EU as an important contributor to inefficiencies. I've heard some argue that it is too easy to say this as different CCPs clear different asset classes. That is correct to a certain extent. For certain asset classes, such as credit, debt, and interest rate derivatives only one or a few EU CCPs offer services. For equities, however, which are crucial to the SIU, the EU counts 10 CCPs, and the EU equity clearing landscape is still fragmented along national lines.[7]

Often the US is mentioned as a reference, where all equity trades are cleared by one large CCP, the NSCC. This single equities post-trade infrastructure was created in 1973 as a result of the 'paperwork crisis'. At the time, shares were handled in paper form. When trading volumes surged, the reliance on manual transactions was untenable with large backlogs and many errors. Firms were forced to automate and dematerialise securities in a centralised data system, created under the leadership of the NYSE. Europe's history is different. Even though dematerialisation was also implemented here, no consolidation took place.[8]

Indeed, a single CCP such as the NSCC brings efficiencies. Past studies have demonstrated that - from the standpoint of an investor - the clearing and settlement cost of an equities transaction in the EU was multiple times higher than in the United States.[9] A ballpark estimate still confirms that the cost of clearing cash equities in the US is lower than the cost of the most competitive EU CCP. Indeed, 10 CCPs require 10 times the organisational overhead, the cost of access and IT systems, risk management systems, and the monitoring of margin payments and settlement fails, not to mention the reduced possibilities of netting.

Discussions on the consolidation of clearing and settlement infrastructures are taking place since the Financial Services Action Plan of 1999. Since then, EU public policy aims to promote more competitive and sounder clearing and settlement systems through competition among EU CCPs. The idea was that increased linkages between CCPs and CSDs would trigger consolidation with the possible emergence of one of a few single infrastructures (Lamfalussy Report, 2001).[10] Consolidation would then reduce fragmentation caused by barriers in market practices and technical standards, legal barriers, and taxation. Public policy focused on stimulating competition and removing national barriers that hindered consolidation. Fifteen barriers were identified by the Giovannini group with measures to overcome these barriers.

However, eliminating fragmentation and inefficiencies has proven to be neither simple nor quick. Since the Giovannini reports, some market features changed for the better. The European Commission has, through its regulatory work, supported a level playing field for competing EU post-trade infrastructures. In the settlement space, the ECB took leadership in creating T2S. In the clearing space, competition took off and clearing fees significantly dropped. For example, for Euronext cleared shares the clearing fees fell from EUR 0.65 to a range of eurocents.

Interoperability among CCPs strongly contributed to this drop in fees. With interoperability trading firms in the equity market can choose one CCP, while its counterparty could be a member of another CCP. PQD statistics of CCPs involved in interoperability of equity trades show that around 30 percent of the value of shares is cleared across the relevant links.[11] The cost of interoperable margins may play a role here, as well as the lack of participation of certain infrastructures.

Preferred clearing is another measure to stimulate competition through 'open access' in the equity markets, where a trade is sent to a trading firm's chosen CCP only if both counterparties select the same CCP. Otherwise, the transaction

[7] ESMA Website, as per 3 September 2024; the tables are published by ESMA in accordance with Article 88(1) of EMIR.
[8] Source: https://www.lexology.com/library/detail.aspx?g=1f852fff-a3f8-475b-96c2-6badec65358a.
[9] Bank of Finland Bulletin, 2020, From Giovannini barriers to Capital Markets Union – Bank of Finland Bulletin (bofbulletin.fi)
[10] European Parliament DIRECTORATE GENERAL FOR INTERNAL POLICIES POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES, ECONOMIC AND MONETARY AFFAIRS, Clearing and Settlement in the EU, STUDY, IP/A/ECON/ST/2008-31, 2009.
[11] See Public Quantitative Disclosures of CBOE Clear, LCH Ltd, and SIS X-Clear, Q1 2024.

is sent to the default CCP of the trading venue. Data on the use of preferred clearing is scarce but anecdotal evidence suggests that preferred clearing is used less than interoperability.

So taking stock of the current situation, we see that over the last 25 years clearing fees in the equity space significantly decreased; still they are higher than in the US. The measures to support competition - interoperability and preferred clearing - have contributed to increased competition but only for a minority of the trades and they have made the investment landscape very complex, while the business has become a penny business with low profits. In terms of fragmentation, the number of CCPs has only increased and – according to a report of the European Post-Trade Forum in 2017 – only 5 of the 15 Giovannini barriers can be regarded as having been fully removed.

Looking ahead

How to move forward and benefit from the momentum that the SIU brings?

One way is to continue on the current road of promoting competition among EU CCPs by further enhancing the level playing field, trying to perfectionate interoperability and preferred clearing, while addressing the remaining unaddressed Giovannini barriers.

Another, possibly even more important, way is to re-evaluate the paradigm of consolidation through competition among EU CCPs and instead focus more on the competitiveness of the EU versus other jurisdictions. This would mean enhanced efforts towards consolidation of EU CCPs through collaboration and alliances. I believe in line with ESMA's Effective Capital Markets report that we need to shift our focus to eliminating barriers that prohibit such collaboration and alliances.

A radical shift to the creation of a single CCP along the lines of the NSCC model would potentially not only be contentious but also contain risk. Creating a single CCP would raise huge challenges in terms of governance, investments, and operational choices. Such a large project may be prone to failure, and the speed of delivering benefits may be (too) slow.

Given that the governance of CCPs is fully private, a market-led and more gradual approach may potentially work better in delivering efficiencies through collaboration and alliances. Collaboration would entail further harmonisation of systems and procedures. Alliances would go one step further with the aim to reduce the number of CCPs, increase scale and size, reduce cost, decrease complexity, and generally enhance efficiencies.

This requires leadership, with the private sector pro-actively seeking ways to harmonise systems and procedures and pursue alliances. There are various examples where collaboration and alliances among post-trade infrastructures, including CCPs, have worked, in various parts of the EU. The scope of these alliances and consolidations so far has, however, in each case been limited to only a few countries.

A challenge to address is the heterogeneous nature of the EU equities clearing market. It consists of differently sized CCPs in markets that differ in their level of sophistication. Objectives of smaller CCPs are typically different from those of large CCPs. Where the latter focus on profit maximisation through a wide range of cross-border products, clients, and services, smaller CCPs tend to focus on local market development, offering clearing in securities that may not be cleared by other CCPs, for clearing members that may not comply with participation requirements of larger CCPs. Collaboration among EU CCPs should take these differences into account with solutions that support efficiencies EU-wide.

The European Commission – as a follow up to recent roundtables - should set up/revive a group to investigate barriers that prohibit better collaboration and alliances among post-trade infrastructures with the aim to eliminate these.[12] Incentives are important. Changes in clearing practices and clearing systems come with costs related to investments, changing procedures, and changing habits. Incentives, both push and pull, are needed. The European Commission and co-legislators should also ensure that EU competition policy is appropriately calibrated to serve the EU's economic and political priorities.

The use of new technology, such as DLT, needs to be mentioned here. Noyer suggests for the consolidation of settlement systems for T2S to extend its remit to […] settlement of financial instruments on blockchain. While technology is often a driving factor behind consolidation and changes in market structure, and however promising the potential of tokenised assets, digital asset services, and blockchain, the time horizon of this technology is uncertain. Any actions towards collaboration and alliances among CCPs should not wait until the benefits of new technologies materialise. The potential shortening of the settlement cycle to T+1 is a measure that is expected to already contribute to several efficiencies.

Finally, supervision of post-trade infrastructures is an important element of the SIU. ESMA's vision is clear. The European Commission and co-legislators should continue evaluating whether specific areas of EU capital markets may benefit from EU-level supervision, such as CCPs. Supervisory consistency is essential to support collaboration and alliances among EU CCPs.[13] ESMA has shown the benefits of building up supervisory expertise with a pan-EU focus and stands ready to support any further evolution in this field.

About the author(s)

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[12] In conjunction with the launch of its study (planned for the end of 2024) to identify barriers and ways to support the consolidation of investment funds, stock exchanges and post-trading infrastructure, Actions to boost biotechnology and biomanufacturing in EU (europa.eu).

[13] See DNB | AFM Next steps for the European Capital Markets Union (CMU), February 2024, position-paper-cmu-afm-dnb (1).pdf.

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