Europe's post-trade architecture: the ECB's view. A lunchtime round-table discussion, with Peter Praet (ECB), Marcus Zickwolff (Eurex Clearing) and Michael Hofmann (ABN Amro).

Held on Thursday, December 1, 2011 from 12.30pm to 2.15pm.
At the Regus Business Center, An der Welle 4, 60322, Frankfurt

Part of the DTCC/CSFI Post-trade Fellowship Programme, with special support from Alpheus Solutions GmbH.

The meeting was organised in Frankfurt to help the Fellowship to a better understanding of the European Central Bank's post-trade policy and its growing importance for the sector. Peter Praet, the main speaker, was appointed to the ECB Executive Board in June 2011 with responsibilities that include market Infrastructure, having previously been the executive director of the Belgian National Bank with responsibility for financial stability for more than a decade.

The follow up speakers were Marcus Zickwolff, Head of Trading & Clearing System Design at Eurex, the derivative exchange of the Deutsche Börse group, and Michael Hofmann, Managing Director of ABN AMRO Clearing in Frankfurt.

The meeting was well attended, with nearly 60 people present. Most were Frankfurt-based, with a few from London and two from the US.

The ECB has three main policies that impact on post trade: T2S in securities settlement; CCBM2 for the management of collateral in the Eurosystem; and its location policy, aimed at having important clearing houses for euro-denominated instruments in the eurozone. All these policies have come to the fore at different times and for different reasons. All are to a greater or lesser degree controversial. In addition, the ECB is putting a lot of thought into the subject of CCP resolution.

The meeting was held at a sensitive time, with the Euro crisis in full spate. The debate took place under the Chatham house rule, meaning that remarks could not be attributed subsequently to individual participants: a fact that is reflected in this summary.

Two questions were posed at the start of the discussion: i) as to the overall philosophy of the European Central Bank in post-trade policy and ii) whether we are not at a turning point in European post-trade policy that will see central banks playing an ever greater role because of their strength, resources and hands-on market experience compared with other institutions such as the European Commission’s DG Markt and ESMA. This prompted a question whether regulation of the post-trade sector would in future have a predominantly central bank, macro-prudential orientation, leading to the eclipse of the “efficiency” agenda of the first few years of this century.

It transpired that the ECB’s post-trade philosophy had to be seen in the context of the bank’s overall quest for efficiency and resilience of the financial system as a whole. Behind this lay the question as to whether to trust change to markets or bureaucrats. The goal in the past 10 years – reflected also in the Basel and G20 regulatory processes - was to find solutions in cooperation with the private sector.
It became apparent that the ECB takes a holistic approach to post-trade issues rather than looking at them in isolation. This meant looking at other activities along the value chain and in particular the role and development of large banks.

By being big, such institutions could create internal infrastructures and become quasi-financial market infrastructures (FMIs) in themselves. This was one aspect of the ongoing debate among regulators and policy makers on how to treat SIFIs (systemically important financial institutions) to ensure that the tax payer never again had to bail out financial institutions that were deemed too big to fail.

The need to focus on SIFIs was accentuated by the failure of the price mechanism during the crisis. The price of financial instruments should serve to signal discipline in financial institutions. But this mechanism went wrong following changes to incentives in the governance of risk that arose in big banks after governments started to guarantee customer deposits. Among the consequences were banks that were too big to fail and moral hazard.

Not that a “one size fits all” analysis could be applied to SIFIs. The roughly 20% pre-crisis return on equity that characterised the large universal banks such as BNP Paribas or Deutsche Bank reflected the fruits of risk-taking, benefits from infrastructure network effects and information technology. The RoE aspiring to by investment banks such as Goldman Sachs reflected their deployment of human capital.

The fact that some major institutions had become quasi-FMIs meant the traditional distinction between investment banking and commercial banking was no longer the whole story for regulators. Instead, policy makers had to look at the division between the utility part of large institutions and their risk-taking parts, including how such institutions could become risk brokers and risk takers at the same time.

A principal policy response, exemplified by the US Dodd Frank Act, was to shift OTC derivatives transactions away from the internalised systems of large financial institutions onto CCPs and organised trading platforms with the aim of make them more transparent.

But there were big unanswered questions about this new model. There was uncertainty as to whether the architecture of the system could be adequately re-engineered because the shift of trades to a CCP required a standardisation of the instruments cleared.

The new model meant market-makers could have to take on basis risk (the risk that the change in the price of a hedge might not match the change in the price of the asset it hedges), which could become a huge challenge.

Suppose that a tailor-made instrument could be divided it into a standardised part that could be cleared by a CCP and a non-standardised part. That would leave uncertainty about how to risk-manage the non-standardised part.

If a choice were made to keep the efficiency of the internalised infrastructure in SIFIs while trying to move risk outside to FMIs, there would have to be assurances that the outside structures, notably the CCPs, worked.
There were implications here for the design of a system to deal with the SIFI problem and discussions among central banks on the resilience of FMI s. The issue of risk managing non-standardised instruments was something that the ECB was looking at with the Bank of England.

One worry that the ECB has highlighted in the past (at an on-the-record EU Commission conference in Brussels on October 24th 2011) concerned the double concentration of risk in CCPs and their large clearing members. The question was not just how to manage the resilience of the CCP itself. If a CCP went wrong, it would mean usually that one or more of the participants were in trouble.

If large clearing members got into difficulties, it was not so clear which was the best architectural model to ensure resilience of CCPs. One approach was to concentrate on economies of scale. But huge infrastructures produced a double concentration risk which was accentuated in multiproduct multicurrency CCPs. And a defaulting participant, which might have a key effect on the CCP, could be a clearing member located in another country.

This was one aspect of the ECB’s location policy, which at the time of the meeting was at the centre of a dispute between the UK Treasury and the ECB in which the UK had initiated proceedings at the European Court of Justice. The ECB’s aim of having large CCPs handling euro instruments in the euro zone should be seen as an issue of oversight rather than industrial policy. The discussion also indicated some unease at the ECB on the question of swap arrangements, should a CCP in London ask for euros from the ECB in an emergency. It was apparent that there were unresolved issues here.

Uncertainty and complexity emerged as twin themes in the meeting. On T2S, the ECB is on the record (at a conference in Frankfurt on October 4-5) as having underlined its determination to finalise the project so that CSDs could start signing up in April. But other institutions with different interests were in this space. The users were in favour. CSDs less so. The Commission wanted to define what a CSD was. Harmonisation was a major issue relating to T2S which would affect whether it would act as a catalyst for consolidation of settlement infrastructures.

There were problems surrounding CCBM2, the Eurosystem project for managing collateral among eurozone central banks. It had become overcomplicated because its designers tried to make it fit with existing infrastructures rather than start from scratch. There was no clear timeline as to when the project might be finished, prompting some discussion as to whether the private sector should be allowed or invited to take it over.

The discussion revealed concerns on the part of users and infrastructure providers about several other aspects of central bank post-trade policies.

One participant was worried that the soon-to-emerge CPSS- IOSCO standards for FMI s could prove more demanding than foreshadowed when eventually published in March 2012. He pointed to the risks arising from overlapping timelines for finalising CPSS- IOSCO and EMIR, the EU’s regulation for clearing the OTC market and CCPs, that could produce contradictory requirements for CCPs.

He cited concerns about different requirements relating to the size of CCP default funds for credit and liquidity risk; differences on the acceptance of collateral by CCPs; differences on governance especially in the definition of risk committees of CCPs; and differences on the appropriate arrangements for the segregation of participant assets as well as portability for customers.
This participant voiced particular concern that the Basel III regime overstated the capital requirements of banks in relation to CCPs and did not reflect the prudent risk management services that CCPs provided. Basel III currently took no account of the performance of CCPs in managing the defaults of Lehman Brothers and more recently of MF Global. CCPs in those two cases were more than adequately collateralised. The Basle committee should engage in further studies and publish the data on which it based its proposals.

There were worries about the need to keep projects aligned on a worldwide basis to avoid regulatory arbitrage. There needed to be agreement on products to be standardised and cleared. Liquidity was also an important issue, not just for markets but also for managing defaults.

The debate revealed widespread concern about the “flood” of initiatives emerging in parallel around the world as well as their complexity and their potential to overload users of financial infrastructures.

As one speaker put it: Not only were teams of doctors trying to deal with different complaints at the same time. The financial sector was confronted with competing teams of doctors working on the same organ.

There were many open issues and unanswered questions, not least regarding pricing and technology. Mistakes would be made. A particular risk concerned long-term projects such as T2S in a time of great change in financial markets. There was a danger that all the initiatives would yield neither savings nor greater efficiency. Why, one participant asked, did everything have to happen at such a pace and all at the same time? It was a “forced evolution”.

It might be that T2S, for example, was a pre-emptive move just as the creation of DTCC had followed from strong action by the American Congress and SEC in the 1970s. But it was also dangerous for Europe to launch projects with the promise of correction and corrective measures along the way.

There was also a danger of politicians thinking that CCPs were the answer to risk: a holy Grail. They didn’t realise they needed liquidity, historic pricing and benchmarking. One participant made a plea for sensible regulation while at the same time expressing doubts as to whether putting all OTC trades onto a CCP would solve the issue.

Clearing might be a step in the right direction but this participant didn’t want to see the contingency money that his bank paid into a CCP being used to clear an asset that had never been cleared in his lifetime. That was capital at risk. At the same time, separating things out by asset class risked fragmentation of the market.

Concerns about the volume and complexity of the new regulations were echoed by a participant based in the USA, who warned of the need for vigilance against regulatory arbitrage and awareness of developments in Asia.

There were some positive suggestions amid the gloom. One participant made a forceful plea for trade transparency and trade repositories to avoid conditions that contributed to the crisis. Another called for legal identifiers to be made a focus of regulation to create more joined-up markets.
Several speakers brought up EU proposals for a financial transactions tax, which is strongly supported by the governments of France and Germany. The FTT is more than a post-trade issue. But the hostility towards the tax on the part of Frankfurt-based users and providers of financial infrastructure services was striking and, for visitors to the city, rather surprising.

One speaker warned that talk of the FTT was generating growing nervousness and a hedging of bets among his client base. People were eyeing the possibility of shifting activity to Switzerland or to Singapore. Money could flow from the EU in seconds. The more initiatives and ideas there were, the more nervous the market became.

However, there was no sign that hostility towards the tax in Frankfurt would be followed up by any lobbying of the government in Berlin to drop its support for the measure.

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