

# Western European

**Thomas Murray** analyse capital market infrastructure risk in Western Europe and highlight key market-level developments within the region

Western European markets are amongst the oldest capital markets in the world, with the first stock exchanges and central securities depositories evolving there. The region's clearing and settlement infrastructures have continued to lead the world in innovation in systems and risk management techniques, so it is no surprise that Western Europe scores consistently highest across all risk exposure areas monitored by the Thomas Murray Capital Market Infrastructure Risk Ratings (CMIRR) service.

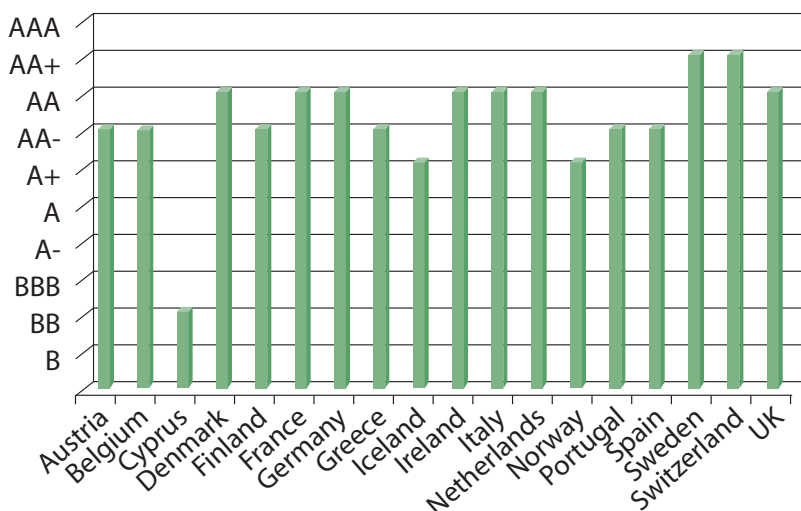
Western European CSDs were some of the first to implement Real-Time Gross Settlement (RTGS) systems, minimising processing times and providing instantaneous Delivery Versus Payment (DVP). Unfortunately, it became rapidly clear that the liquidity costs of such systems in high volume markets were enormous, and necessitated the development of sophisticated collateralisation models (e.g. UK, France, and Germany) that require enormous levels of collateral throughout the region's markets on a daily basis. However, these Old World markets have again shown their willingness to adapt to this kind of challenge, by cross-breeding RTGS and multilateral netting processes to produce hybrid systems that 'optimise' settlement by identifying chains within the real-time settlement queue. Some markets, such as Italy, are still going through the pains of evolving through these models, but at least the precedents have been set and lessons can be learnt from the mistakes of others.

The region's attitude to fails management and settlement assurance still reflects a tension in how much the infrastructure should interfere in the control of risk exposures from late settlement or total counterparty default. Central counterparties (CCPs) have been embraced by many markets as the 'must-have' risk management structure against participant default, although not all countries have jumped on the CCP bandwagon. Most notably the Scandinavian markets have evaluated the costs versus rewards of the CCP model and found the case wanting. It remains to be seen whether the CCP's legal obligation to assure settlement confers any advantages over properly

resourced non-CCP guarantee facilities in the event of a major default.

Worryingly, some markets have been reducing the values of guarantee funds and collateral recently (e.g. Greece, Switzerland), while others have been suffering settlement delays owing to high volumes stressing settlement flows and optimisation systems (e.g., Austria, Euronext, Finland, Germany, Italy, Sweden). Some compensation has been seen in markets rearranging fining structures and buy-in arrangements (e.g. LCH.Clearnet, potentially Italy and Sweden), but there is widespread reluctance in the region to force settlement through soon after contractual settlement date by early buy-ins or heavy fines (rolling over failing settlements up to SD+10 before enforcing a buy-in seems to be the regional norm). If these trends continue, it could increase potential exposures from late settlements or defaults.

Fig 1: Thomas Murray Western Europe Capital Markets Infrastructure Risk Ratings



# Capital Markets Infrastructures

In terms of financial risk exposure, Western European market infrastructure participants are some of the best capitalised, especially those that are part of vertical silos (e.g. Germany, Italy), and are consistently profitable. A notable exception, however, is the Austrian central counterparty, CCP.A, which only has €35,000 in net capital, the minimum permissible under Austrian law. Most exchanges, CCPs and CSDs have robust insurance coverage, access to credit lines and limit their potential claims against them through tight contractual liability arrangements. The banking sectors in virtually all the markets are robust and the sovereign credit ratings of the countries (especially those in the EU) are very strong. This effectively suggests that it would be highly unlikely that economic conditions would develop in these markets that would inhibit foreign currency exchange, repatriation of proceeds or the provision of credit.

Operational risk exposures in the capital market participants in the area are rigorously controlled, with sound operational controls and procedures confirmed by regular external operational audits (some in SAS70 form). Most Western European markets hold securities in dematerialised, registered form, which is probably the most secure against theft, fraud and loss. Those that hold securities in immobilised, bearer form (Austria, Belgium, Germany, Italy (for bonds), Netherlands, and Switzerland) face pressure from market participants and system operators to dematerialise (Belgium, Netherlands) or register securities (indirectly from the EU Commission through any directive on proxy voting which may abolish share blocking). Disaster recovery procedures in all markets appear at least to be adequate and should be able to continue trading, clearing and settlement in the event of a disaster.

The major infrastructure project that may raise operational risk issues is that of the Euroclear markets, with its implementation of the Single Settlement Engine (SSE), Euroclear Settlement of Euronext Securities (ESES) and eventually the Single Application Platform (SAP). This process has just begun bearing fruit with the recent implementation of the SSE in France, with UK and Euroclear Bank (2006) and Belgium and Netherlands (2007) to follow, but the overall project is likely to continue through to 2009-10. The potential disruption as market participants change over systems and procedures is therefore likely to last for several years, and there is no clear consensus regarding whether cost savings and operational efficiencies will be realised as predicted.

## CMIRR Ratings Definitions:

AAA	extremely low
AA+	} very low
AA	
AA-	
A+	} low
A	
A-	
BBB	acceptable
BB	less than acceptable
B	quite high
CCC	high
CC	very high
C	beyond any acceptable level of risk exposure

## Regional Consolidations and alliances

In recent years, the development of capital markets in Western Europe has been driven not only by a desire to comply with international standards such as G30 and CPSS-IOSCO, but also, perhaps more importantly, by regulatory and economic drivers to harmonise local market

practice and legislation to allow for efficient, low cost cross-border investment. The Giovannini and Lamfalussy reports, along with the recommendations and threats from CESR, CESAME and the EU have, however, been slow to effect harmonisation and the desired consolidation. Inevitably, it has been market forces that have dictated the pace of change via exchange mergers, necessitating re-engineering of clearing and settlement infrastructure. This has been led by Euronext, which has been doing the most practical work in harmonising market practice in Belgium, France, Netherlands and Portugal, as well as the Scandinavian exchanges through the NOREX Alliance and the activities of OMX.

Exchange consolidation is going to alter the clearing and settlement landscape, not necessarily into a shape predicted or desired by market participants and European regulators. With the US exchanges looking likely to acquire much of the trading volume in Europe through the LSE/NASDAQ and NYSE/Euronext tie-ups (with the possibility of Borsa Italiana entering in a three-way deal), how will this influence the European clearing and settlement landscape? Will we perhaps see the re-entry of DTC into Europe, or NSCC as an alternative central counterparty?

The other market tie-up worth noting is between Greece and Cyprus, whereby the Cyprus Stock Exchange (CSE) will take the ATHEX trading system, OASIS, and the Central Depository and Central Registry (CDCR) will take the CSD SA (Greek central depository) system, DSS (Dematerialised Securities System). Market procedures and regulations are being harmonised and the common trading and settlement platform is due to go live on 19 June.

### Current Developments:

**Euronext** – Euronext merger with NYSE agreed in principal subject to shareholder approval. Merger talks with Borsa Italiana have begun.

**LCH.Clearnet S.A.** – New fining policy and modified buy-in process introduced in France, Belgium and Netherlands.

**Euroclear** – Single Settlement Engine was introduced in France on 29 May, and is due to go into Belgium and Netherlands in 2007 alongside the Euroclear Settlement for Euronext Securities (ESES) process.

**Cyprus** – Common trading and clearing platform with Greece to go live on 19 June. This will allow cross-market access to Greek and Cypriot brokers. Adoption of Greek clearing and settlement practices in Cyprus should improve the market.

**Denmark** – VP has purchased Danske Bank's and Nordea Bank's shareholder register activities and looks likely to consolidate others to establish itself as the central registrar for the market. BIC code usage will be extended from November 2006.

**Finland** – APK has introduced further optimisation batches into HEXCLEAR. APK rule changes have been ratified, which brings them into line with VPC rules under the NCSA Group.

**Greece** – ATHEX has restructured its guarantee funds, extending the Supplementary Fund's coverage, but by using a more risk-based calculation for funding, they will reduce broker contributions by around €80 million. Hellenic Exchanges has proposed to reorganise itself to reduce its VAT burden on intra-group fund transfers. The suggested new structure would bring the ADECH (Derivatives Clearing House) and CSD SA into the Hellenic Exchanges holding company.

**Italy** – Possible merger of Borsa Italiana with Euronext would require break-up of Italian vertical silo, calling into question the long-term future of Monte Titoli and especially CCG, the Italian CCP. Unification of the RRG matching engine is due from 10 July. Monte Titoli participants have suggested several solutions to the ongoing settlement problems, including mini-netting cycles, self-collateralisation and extra processing batches.

**Portugal** – Settlement Connect will be launched between 23 and 26 June. Interbolsa implemented a centralised securities lending and borrowing system, called SGE, on 22 May.

**Spain** – The Spanish exchange group, Bolsas y Mercados Españoles (BME), has appointed Rothschild as its advisor for the company's public share offering. BME has called an Extraordinary General Meeting for 5 June to approve the IPO.

**Sweden** – Increasing fail rates in the market have prompted VPC to consider introducing late settlement penalties or imposing a maximum value cap on transactions.

**UK** – Single Settlement Engine to be implemented in CREST in August 2006. A new clearing model for the integration of EquityClear has been proposed which would see CREST CCP services and LCH.Clearnet Ltd's Clearing21 operate in parallel. LSE has signed a deal with SIS x-clear, the Swiss CCP, which will see x-clear offer CCP services to LSE from around June 2007. ■