CLEARING AND SETTLEMENT: Clearing the way

Europe's cumbersome clearing and settlement process is still some way off the sleek US model, finds *Angelique Ruzicka*, despite efforts to develop it

Asset managers and their providers appear slow to adapt to change in the environment of clearing and settlement, especially when it comes to exotic instruments like over-the-counter (OTC) derivatives. But the industry should move more quickly if it is going to be able to deal with the volume of trade in these new exotic instruments.

Evidence that trades in exotics are starting to overtake traditional instrument trading is already available. According to the Bank for International Settlements there was an 82% growth in the turnover of foreign exchange swaps in April 2007, while turnover in traditional foreign exchange instruments increased by 71%.

Growth in the derivatives industry may be good news to some, but the news about how they are traded and settled is not all that good. According to the International Swaps and Derivatives Association (ISDA) in 2006 and 2007 there were trade booking errors of around 20% for credit derivatives and over 10% for plain vanilla interest swaps. In addition, trade confirmation times can take as long as 21 days.

Tony Freeman, director of industry relations EMEA at Omgeo, says: "I don't think the clearing and settlement industry is anywhere near where it needs to be. The pace of change has been quite slow. There has been some consolidation but far less than you would anticipate if Europe is going to become a single market."

Manual processing

Processing headaches is a problem that is widespread from the front to the back offices. But it's the back offices that have to deal with missing or incorrect information and the risks involved.

One of the key problems is that derivative trades are still processed manually by fax and phone and most asset management firms' systems are largely still paper based. But this could all change as the industry has been down this road before. About a decade ago, the same issues used to hamper equities markets as there was a time when traditional products were all processed manually. "Ten years ago, we were talking about codes of best practice for the equities market and at its simplest level that is what's going on in the OTC derivatives market. Documentation standardisation needs to be key within the OTC world," says Geoff Harries, director of securities product management for CheckFree.

"The OTC world was very manual, especially in the buyside community, and that largely exists today. It's a natural evolution as people start to increase their volumes, start to look at their manual processes, the benefits of efficiency from a litigation point of view," he adds.

But the problem of manual processing still remains, and as a result it can take days or weeks before exotic trades are legally confirmed and the result includes discrepancy between trades, unreconciled positions, inaccurate entries into the P&L account and failure to make punctual payments.

Up to this point the regulators have taken a light-touch approach to the situation, with the EC issuing a voluntary code of conduct.

Harries, at CheckFree, says: “Over the last year… there was more pressure from the Federal Reserve and the UK’s Financial Services Authority (FSA) to use electronic confirmation platforms. They weren’t prescriptive in what they wanted, but most of the largest firms usually install Swapswire or the DTCC’s Deriv/Serve platforms. That was the catalyst for us to make changes to our product. It was not so much an imperative; it’s more of a guideline for people to automate what had become an industry problem, that of confirmation backlogs.”

The market is still very fragmented and the cost of settling a trade is much higher than in the US. Questions are constantly being asked about this discrepancy and whether Europe can come down in price to at least match the US.

Currently there is a whole host of different securities clearing houses and central depository systems across Europe and that is part of the reason for the higher clearing and settlement costs. According to Euroclear, the price tag of a cross-border trade in Europe is between e5 and e20, but a domestic trade costs a mere 35 eurocents. Meanwhile, in the US the cost of clearing and settlement can be as low as 10 cents in the DTCC system, the country’s sole depository.

One solution for bringing down the prices in Europe could be increased competition, but Hugh Cumberland, manager of BT Global Financial Services, argues that the opposite needs to occur. “If you look at the US, the DTCC is a monopoly, yet it has become very efficient and can process very high volumes by comparison to anywhere else in the world,” he says.

In Europe there has been no centralised force but Euroclear has started to take the lead in creating such a platform. “Euroclear has jumped up and consolidated a number of central securities depositories (CSDs) in the UK, Ireland, France, Belgium and the Netherlands.They are offering the industry significant annual savings by bringing all of those together on one platform. The result is you have less process, less people,” says Cumberland.

But the prospect of Euroclear having the ultimate monopoly in Europe is uncertain as the European Central Bank has the same idea. It has ambitions to build a single settlement system for Eurozone securities called Target 2 Securities (T2S).

Perceived threat

Freeman, at Omgeo, says: “Some people call it nationalisation. It’s perceived to be a threat to some of the CSDs and some of the banks that are specialists in their market, because it harmonises everything in one place. Its ambition is purely to be a settlement process and not to offer all the value-added clearing and settlement processes that custodians do. If it goes ahead, it will have an impact on the business case for organisations in this area. The timetable for putting it in place is very long but they will make the decision in June about whether to go ahead with the project.”

Finally, Project Turquoise, the pan European equities trading platform created by Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley and UBS, could also pose a threat to CSDs and promote change. Last year it selected EuroCCP, a European subsidiary of DTCC, to provide clearance and settlement services for the new venture.

There is evidence though to show that settling trades early can be done. “People seem happy with the status quo now,” points out Cumberland. “I am surprised that some of the evolving securities markets that haven’t had the legacy we have had, have been able to settle within a day or less. Places like Singapore for instance with no legacy behind it to deal with show it can be done. But we now have a situation where securities trade settlement periods are not uniform.”

Outsourcing exotics

While the debate rages on about whether a single settlement system is the best way forward for Europe there is also the issue of automation. Automation of exotic instrument trades may be inevitable but there is the problem of how and when to do this. The common consensus among industry commentators about how to deal with this problem appears to be to outsource it.

There are, of course, various different models of outsourcing and while there have been horror stories in the past there are more success stories coming to the fore. “Everyone knows about the story of JPMorgan and Schroders and how that went on and on and then fell through,” says Cumberland. “There are other success stories too but you don’t hear too much about them. Unless the custodian gets their megaphone out and shouts about it, it’s not in the news.”

There are always going to be arguments both ways, but the reasons for keeping back office operations in-house and attempting to automate with in-house systems is slowly falling by the wayside. Cumberland recommends asking these questions: “To what extent do you continually want to be involved in the innovation in the world of operations? As instruments evolve and settlement and clearing evolves, how much do you want to keep yourself invested in keeping your systems and staff up to date? Where does your skill really lie?”

e points out how hedge funds deal with processing exotic instruments. “Hedge fund managers didn’t want to do this so they got someone else to do it for him. It was never in question. If you visit a hedge fund manager you appreciate how small their operations are and how lean they are,” he says. “There are experts in the industry that do this for a living. For many asset managers there may be an emotional attachment to the operations side. But this is not an emotional industry anymore it’s all about numbers.”

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