

Omgeo and EuroCCP pilot OTC Central Clearing Initiative

Omgeo and EuroCCP have combined their expertise to develop a central counterparty service for pan-European equities trading by the hedge fund community. Bob Currie talks to **Leigh Walters**, Executive Director, Global Sales and EMEA at Omgeo, and **Martin Brennan**, Omgeo's Director of Business Development, about the origins and evolution of the project

Traditionally, settlement of trades across the hedge fund-prime broker-executing broker processing chain has been handled as a series of bilateral OTC transactions without the guarantee of a central counterparty. Under this Omgeo-EuroCCP joint initiative, EuroCCP will step in as central counterparty in the settlement chain, thereby mitigating counterparty risk between prime broker and executing broker prior to settlement and the associated exposure of the hedge fund to the executing broker. Importantly, the CCP will extend the benefit of netting prior to settlement, thus helping the parties involved to reduce settlement costs and to manage their liquidity needs more efficiently.

The model will build on Omgeo's long standing expertise in the electronic trade confirmation space, utilising Omgeo Central Trade Manager (CTM) to handle trade matching and block allocations between buy-side firm and executing broker. When a trade has been confirmed on CTM and has been authorised by the prime broker, this trade information can be presented to the CCP, whereby it will settle at the relevant European CSD on a netted basis.

This solution offers important advantages in promoting operational efficiency and limiting counterparty risk. Under the existing workflow (Fig 1), trading parties bear exposure to their counterparties from execution through to the trade settling on T+3. Under the revised workflow (Fig 2), the central counterparty will novate the transaction, which will then proceed to settlement as a locked in trade with settlement guaranteed by the CCP. With the collapse of Bear Stearns and Lehman Brothers (among others) still fresh in industry minds, this transition to a centrally cleared environment for the buy-side is undoubtedly attractive in mitigating the counterparty risk that prevails under existing bilateral trade-for-trade settlement arrangements.

A virtue of the service, argues Martin Brennan, is that this draws on existing facilities extended by Omgeo and EuroCCP and does not require development of further technology or infrastructure. Operational inefficiencies have long prevailed in the hedge fund/prime broker/executing broker processing chain because the parties involved have allowed them to persist. The major impediment to change



Leigh Walters,
Executive Director, Global Sales
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is not the development of the necessary technology – rather it is in encouraging firms to change their behaviour. Most would agree that the desired end result in executing a hedge fund transaction is DvP settlement at the relevant CSD. But in reaching this goal, multiple intermediaries are involved and levels of manual intervention across some stages of this process flow are substantially higher than they should be.

Linking CTM into clearing and settlement

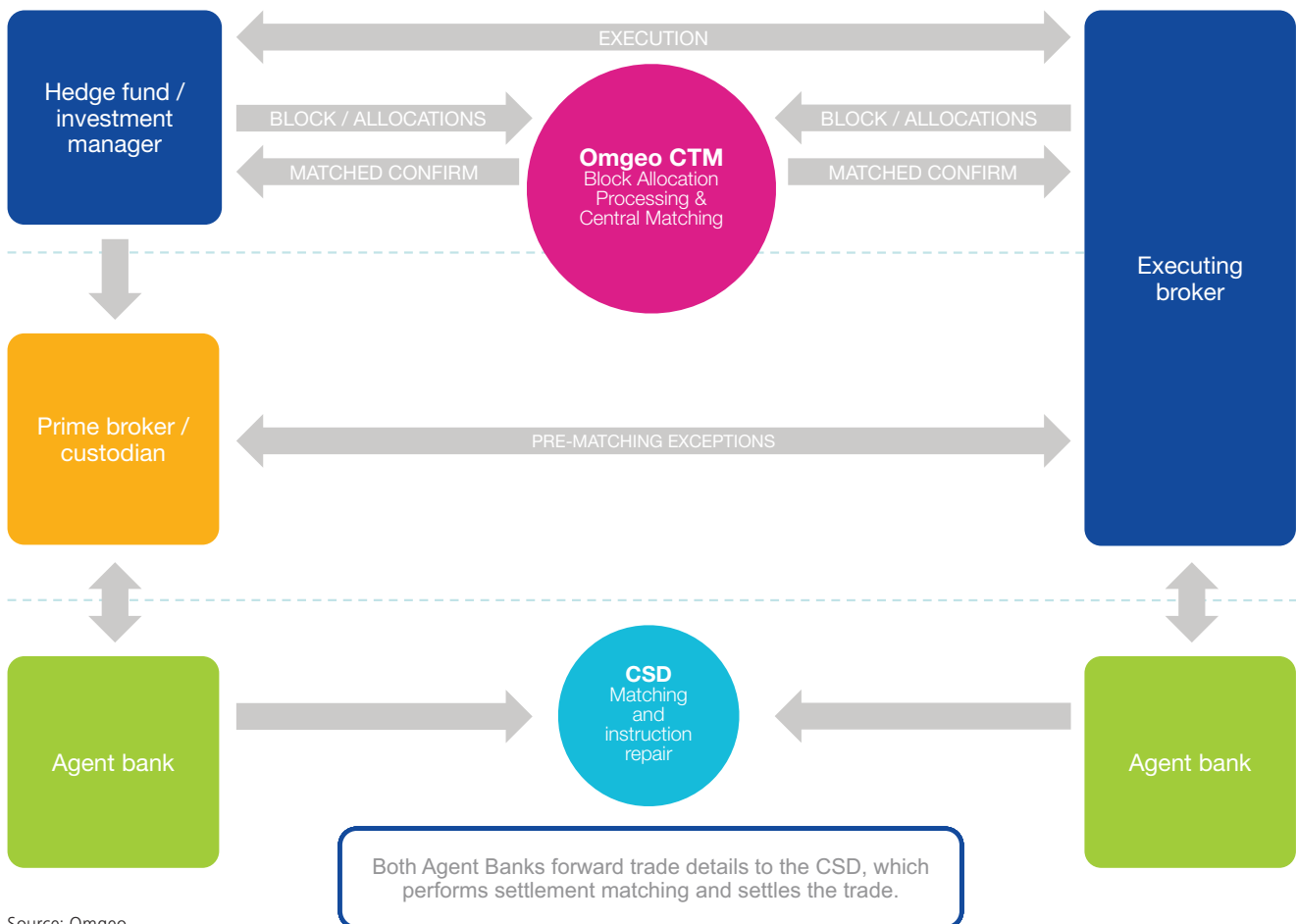
A buy-side customer might use Omgeo CTM to match trade instructions and to manage trade allocations with its executing broker. However, Omgeo’s involvement in the trade lifecycle has traditionally stopped there. Downstream of this point, the buy-side customer will typically send a trade confirmation to its custodian (or prime broker performing the custodian function)

and the custodian will compare (ie ‘pre-match’) these trade details against those held by the executing broker. If a suitable match is in place, these parties will pass settlement instructions to the CSD (either directly or via their local agent banks, see Fig 1), whereby the trade will settle if required funds and securities are in position at the relevant client accounts. In case of a mismatch, custodian and executing broker may need to intervene manually to identify and repair the discrepancy between their settlement instructions.

For a buy-side firm that has multiple custodian accounts across 10 or 15 markets in Europe, these post-trade complexities can result in duplication of effort and present a hurdle to the goal of delivering automated end-to-end transaction management.

For buy-side firms and brokers that are connected to Omgeo CTM, however, the

Fig 1: Existing workflow



Source: Omgeo

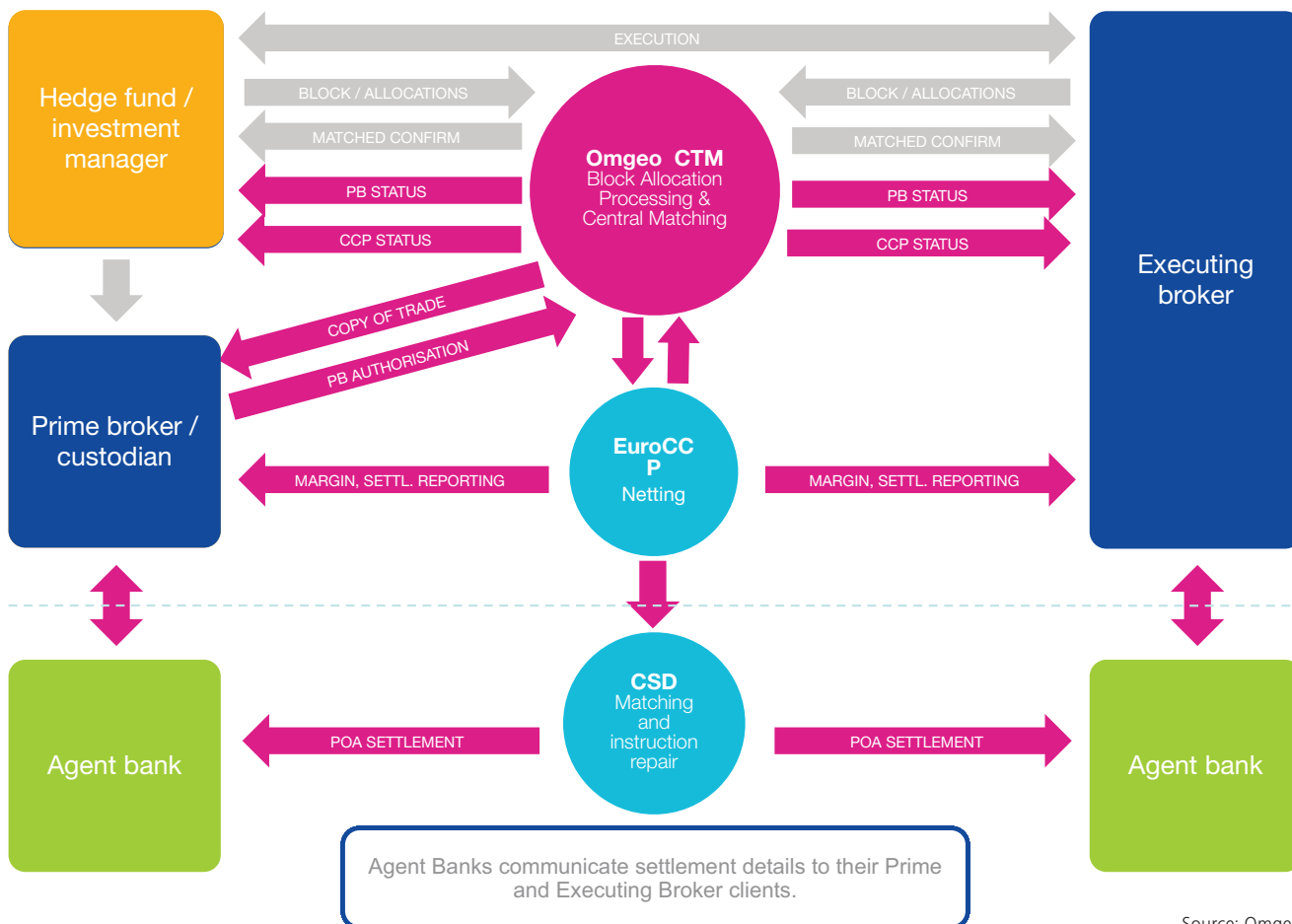
tools are already in place to strip much of this inefficiency out of the processing chain. The key, notes Leigh Walters, is to hook Omgeo CTM more directly into the post-trade architecture, using this matching and allocation information from CTM to support clearing and settlement, with the transaction enriched (as necessary) from Omgeo's ALERT reference database of standing settlement and account instructions. When a trade is matched centrally on CTM, trade instructions can be routed to the custodian/prime broker on T+0 for authorisation and consequently forwarded to the CCP. By confirming a trade match in Omgeo CTM, this will eliminate the need for an additional stage of pre-settlement matching between custodian and executing broker prior to issuing settlement instructions to the CSD.

Importantly, notes Leigh Walters, the netting benefits are huge. In preliminary testing, one prime broker highlighted 73

per cent netting efficiency for hedge fund transactions processed on behalf of its hedge fund clients. With average settlement fees in Europe roughly €10-20 per trade and average clearing cost at the CCP roughly €0.05 per trade, this heralds a sizeable potential cost saving.

Some minor refinements to Omgeo's CTM facility have been necessary in order to support the new service. In this uncertain financial climate, growing numbers of hedge funds are establishing multiple prime broker relationships in order to limit potential counterparty risk against a single PB. This has reinforced the need to have clear identifiers in place to verify which hedge fund transactions belong to each PB relationship. To meet this requirement, Omgeo has built a PB identifier into its central matching solution such that all parties can be clear which hedge fund, prime and execution brokers are associated with each transaction.

Fig 2: Revised workflow



Source: Omgeo



Martin Brennan,
Director of Business
Development, Omgeo

Open architecture

During the trial phase, EuroCCP will extend central counterparty services with trades settling through Citi as EuroCCP's appointed settlement agent. However, the model is designed to be generic: this will provide open access to other CCPs, in compliance with Article 84 of the European Code of Conduct on Clearing and Settlement, should users wish their trade flow to be routed to another clearing provider. So too, the model is interoperable at the central matching engine level. The prototype has been built by Omgeo and EuroCCP to support trade matching from CTM, but the model supports an open architecture that will enable alternative ETC engines to assume this function.

On consultation with prime brokers and hedge funds involved in the testing phase, the Omgeo-EuroCCP model will support end-to-end trade processing for liquid equities trades across the 15 markets currently serviced by EuroCCP in the early phase of its release. However, there are clear intentions to extend this facility to a broader range of traded instruments as the service matures – potentially embracing fixed income securities, exchange-traded derivatives, foreign exchange or repo transactions, according to demand from clients.

The overarching message, explains Leigh Walters, is that the project will free buy-side and sell-side firms from much of the risk and inefficiency of processing hedge fund transactions downstream of agreeing the trade details. Having used Omgeo CTM or another ETC system to confirm a matched trade, participants can draw on the services of EuroCCP and its settlement network to process the transaction through to settlement. EuroCCP currently supports clearing services across more than 6000 ISINS in Europe, but has potential to extend this to markets in North America and the Asia Pacific.

Bringing custodians on board?

Having secured buy-in from prime brokers, hedge funds and executing brokers, a sterner challenge might be to bring custodians on board. Will custodians be reluctant to move from their existing market model

to support the Omgeo-EuroCCP proposal for OTC central clearing? "We are in communication with global custodians that are interested to support this programme," comments Brennan, "and several large CSDs may also take an interest as TARGET2-Securities prompts depositories to extend their attentions in the asset servicing space." Though firms active in the multi-direct custody and clearing (MDCC) space in Europe may feel threatened, Brennan is confident that enthusiasm from buy-side customers will encourage custodians to align with the initiative.

Pilot testing for the Omgeo-EuroCCP project has been ongoing during Q4, involving four buy side firms (specifically three hedge funds and one traditional asset management company), a prime broker and two executing brokers. The real fruit, however, will be reaped when the service partners can bring on board a strong body of institutional asset managers, thus prompting a sizeable rise in settlement volume processed via the programme.

Full circle

Though global financial markets have changed greatly over the past two decades, electronic trade confirmation continues to provide a fundamental starting point for eliminating post-trade inefficiencies whether in exchange-traded or privately-traded markets. In the late 1980s, key industry players established an ETC Forum designed to address processing inefficiencies in the UK market subsequent to Big Bang. "This year we recognised that it was a good time to reinvigorate this industry group in order to counter risk and inefficiency across the hedge fund-prime broker-execution broker OTC processing chain," says Brennan. "Rather than simply using Omgeo CTM to secure a trade match between buy-side firm and its executing broker, the key is really to integrate that trade information into the clearing and settlement layers as an STP process. We now have multiple central counterparties in Europe and by using the CCP to secure a locked in, guaranteed settlement, we will reap the benefit of end-to-end STP from trade capture through to settlement for domestic and cross-border trades." ■