



TraianaTM

In the middle of the markets, at the heart of innovation.

Harmony CCP Connect for Equities

White Paper

Contributions from:

Deutsche Bank 

INSTINET
A NOMURA COMPANY 

J.P.Morgan

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Introduction

Harmony CCP Connect for Equities – the Traiana solution that automates the central clearing of OTC equity trades – was launched in October 2014. Used by some of the largest equity broker dealers, the interoperable solution matches and clears OTC equity trades at the preferred clearing house.

Working closely with the industry, we were confident that the benefits of moving from the existing bilateral settlement model to a central clearing (CCP) model were significant. They would include a reduction in counterparty risk, as well as an increase in transparency, cost savings and efficiencies, as CCPs net these trades alongside existing on-exchange flow. All of this would combine to reduce the cost of settlement.

As flow has increased on the service, we're seeing the expected benefits – as well as some unexpected ones – become reality for customers live on the platform. We've asked these customers to discuss their experiences and the benefits they've seen as a result of central clearing and netting for some of their trading activities. The results of these conversations are outlined below.

The immediate and obvious benefits of moving from the existing bilateral settlement model to a central clearing (CCP) model include:

- ▶ Reduction of direct settlement costs
- ▶ Improving efficiencies for settlement teams
- ▶ Reducing failed trades as a result of lowered delivery requirements
- ▶ Reducing borrowing, funding and margin costs
- ▶ Reducing counterparty risk
- ▶ Preventing volume from being a reason to limit trading
- ▶ Ensuring improved regulatory compliance

I hope that you will find the findings from our work with clients useful. It should provide additional context and analysis as to the benefits of using Harmony CCP Connect for Equities to contribute towards overall cost reduction. What is increasingly clear is that as increasing market participants begin to clear OTC equity trades via a CCP, the impact will be felt exponentially by the entire market and Traiana is proud to be part of this process.

Laura Craft

Director Product Strategy – Equity & Fixed Income, Traiana

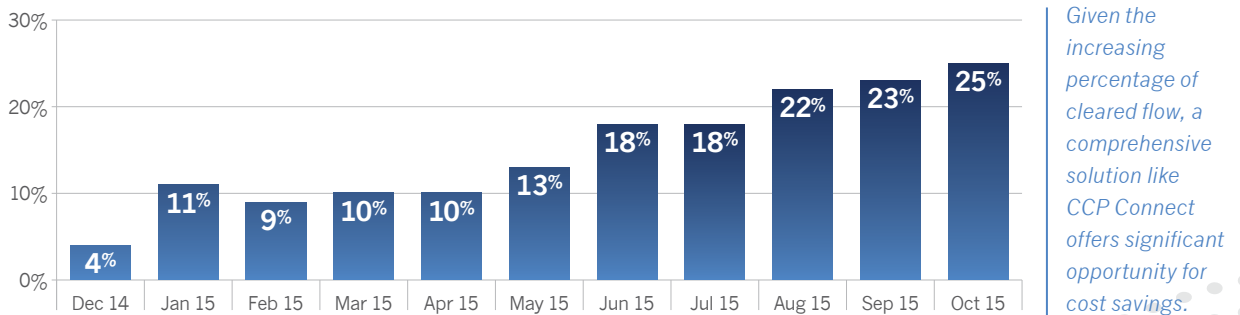
Harmony CCP Connect for Equities

With Harmony CCP Connect – an automated solution for the central clearing of OTC equity trades – executions are matched and cleared alongside trades done on exchanges, allowing executing brokers and prime brokers to net all trading activity. Businesses that absorb cost measured by the number of tickets that proceed to settlement, benefit from the significant reduction in ticket volumes and a corresponding reduction in settlement costs and risks.

With over 90% of OTC trades eligible for clearing, brokers using CCP Connect to clear via a central clearer have the ability to net and clear more than 80% of these trades if all counterparties are connected. CCP Connect is linked to the three pan-European clearing houses (EuroCCP, LCH.Clearnet and Six X-Clear) on a fully interoperable basis. Traiana worked closely with the CCP's and their respective regulators to secure a later netting cycle time of 18:30 UK time for Traiana sourced trades to ensure a greater pool of trades are eligible for clearing, catering for give-ups that are allocated end of day.

The chart below demonstrates the total percentage of hedged trades related to Contracts for Difference (CFD) that are cleared via CCP Connect compared to total flow in the Harmony CFD application. The volume jump since August relates to the later netting cycle cut off time of 18:30 UK time compared to 18:00 UK time at launch.

Give-up flow cleared in CCP Connect



Fabrice Carrier, Managing Director, J.P. Morgan:

“For combinations that are live on CCP Connect, we’re seeing 93% of eligible trades being successfully cleared. As additional brokers and prime brokers come on board, there’s no reason not to see similar percentages across all live combinations.”

Interbank trading via CCP can be netted not just between the two counterparties in a specific trade, but across the market. For the executing bank, this allows individual trades to be netted against its overall market obligations and not just to the specific counterparty for that trade.

Prime broker using CCP Connect for clearing:

“As we add more brokers and PBs to the platform, we should see further increases in the novation ratios.”

It is estimated that the associated savings to settlement costs for individual banks could be significant: at an average of almost \$1.46 equivalent per trade settled, or more in some markets. By combining executing broker and prime brokerage savings, a bank could save upwards of \$2.2 million annually in settlement fees alone as additional brokers and prime brokers come on board.

The cumulative overall impact on the market is significant and is estimated at \$30 million annually.

The cost, operational and risk benefits include:

1. Improved efficiencies for settlement teams

Increased efficiency and the freeing up of resource for more strategic work can be seen in a number of ways.

The reduction in overall volume for settlement positively impacts back office systems, SWIFT payments, agent settlement, CCP settlement and CDS settlement costs.

The equity market's requirement for pre-matching and agent matching processing is particularly labour intensive. By matching the transaction and the risk on the trade date, not only is the process simplified, but opportunities for mistakes are limited – positively impacting the cost of the trade.

Executing broker:

“If you can match on trade date and novate to the CCP, you will never need to pre-match again. There are fewer opportunities for mistakes and we can create a more disciplined marketplace.”

Volume most impacted by CCP Connect is often the most challenging to manage because timeliness of bilateral settlement, often driven by how trades originate (give ups, HFT's, algo trading), increases the risk of mistakes as the window to fix them keeps getting shorter. By clearing and netting this flow, trade errors are reduced and the need for human intervention diminishes, along with exceptions, errors, cash and stock breaks caused by manual intervention. Workloads for settlement teams remain static, providing stability while decoupling workflows from market volumes.

Workflows that see the benefits of this increased efficiency include:

- ▶ Delivery management
- ▶ Post-settlement reconciliations
- ▶ Managing fails
- ▶ Interest claims
- ▶ Funding
- ▶ Asset servicing
- ▶ Cash and stock reconciliations

Prime broker:

“CCP Connect enables firms to effectively manage spikes in volumes without significantly impacting operations resource. Thus allowing the firm to maintain a high level of client service whilst continuing to focus on strategic, value-add initiatives and client activities.”

2. Reduced failed trades as a result of lowered delivery requirements

The bulk of failed trades are the result of a client’s failure to deliver, mismatching or technical errors that prevent settlement. Central clearing via CCP Connect removes bilateral settlement, with significantly improved delivery failure statistics.

It’s expected that overall fail volumes could reduce by at least a third by using central clearing. In August 2015, one CCP Connect client was already seeing this level of reduction, estimating that market fines were reduced by 30% compared to the average for the rest of the year.

Executing broker:

“There’s no doubt that as more flow goes through the CCP there are more netting opportunities and a corresponding reduction in fails.”

3. Reduced borrowing, funding and margin costs

As ticket volumes and delivery requirements decrease, there’s a natural decrease in the cost of funding and borrowing. It is estimated that overnight funding could be reduced by as much as 20%.

Regulatory capital requirements are also impacted, because they require capital to be locked up during processing. Not only is this an increased cost, it also leads to opportunity cost with the capital unavailable for use elsewhere. One client commented: *“The amount of capital that can be tied up by trades on the balance sheet is colossal. A reduction in failed trades reduces both the capital and funding requirements.”*

The reduction in failed trades also has a meaningful impact on collateral and borrowing costs. As we heard from another live participant: *“CCP Connect is making a material difference to the efficiency of the market, leading to a significant decrease in post-trade costs.”*

4. Counterparty risk is reduced

With no need to bilaterally settle underlying trades, counterparty risk is reduced because all processing is done via just one central clearing house. The corresponding impact on overall counterparty risk is notable.

Fabrice Carrier, Managing Director, J.P. Morgan:

“The ability to match and compress via interoperable CCP’s removes the need for bilateral settlement of the underlying trades, and in doing so reduces the inherent risk of both settlement and counterparty failure.”

5. Volume is no longer a reason to limit trading

In high volume markets, the opportunities for mistakes and the associated costs are traditionally higher. With central clearing via CCP Connect, high volume trading sees exponential improvement in efficiencies as increased opportunities for netting are revealed. This increased efficiency ultimately leads to fewer opportunities for settlement failure and further improvements in cost and risk savings.

The current settlement process, and the associated required resource, limits the amount of trade activity possible for each market participant. With no increased need for resource during periods of high trading volumes, there is now no longer any volume cap. As one Executing broker noted: *“This process is ensuring that we become agnostic to volume. By going through a clearing model, you eliminate this volume cap. Using our current processes, we’re very efficient but there’s no room for improvement. This is what we need for the future.”*

Case study:

During August 2015, announcements from the Chinese government drove unprecedented volumes across trading types. The benefits of central clearing via CCP Connect quickly became obvious as trading bottlenecks and errors remained low, even with increased activity needing to be managed. Execution houses found that even trading in illiquid stocks did not raise additional problems, with the ability to net ensuring fewer settlement issues.

It is apparent that over time central clearing will allow firms to reduce their sensitivity to volumes, especially in the more illiquid securities.

6. Regulatory compliance

Regulators globally are pushing for increased use of central clearing across asset class and product types. The process of netting and clearing OTC equity trades is in line with their guidance and reflects the market’s overall efforts to proactively reduce risk, lower volumes and decrease the cost of trading for all market participants.

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