WHY THIRD-PARTY CLEARING MODELS ARE THE ANSWER TO NEW MARKET INFRASTRUCTURE IN ASIA PACIFIC

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In 2017, BNP Paribas released a paper that asked if brokerage firms in Asia Pacific had reached a tipping point. In that paper we highlighted factors that signalled a potential shift towards third-party clearing and away from account operator or self-clearing models. It is now time to revisit that paper and ask: How have Asia Pacific's markets evolved in the last three years? How have ongoing regulatory changes, market activity and technical evolution impacted the direction brokerage firms are taking? And, is 2020 the age of third-party clearing in Asia Pacific?

During the first three months of 2020, markets in Asia Pacific saw record trading volumes as a result of market volatility - reaching as much as 70% in some markets - triggered by the global pandemic. As a result, broker turnover and revenues increased sharply.

However, the sudden growth in activity created challenges. For example, on 17th March the Philippine Stock Exchange suspended trading for equities, FX and bonds. Elsewhere, volatility drove an increase in margin requirements for equities and derivatives trading, putting a strain on liquidity. As a result, some brokers struggled to manage volumes because of insufficient manual back office processing or technical capacity. Indeed, concerns in some markets led to exchanges increasing scrutiny of trading activity by participants as well as placing a greater focus on their technical capacity.

With the potential for continued periods of market volatility and high-volume activity, brokers in Asia Pacific are accelerating restructuring efforts and reexamining target operating models to ensure they have the solutions in place to best manage any potential market stress.

KEEPING PACE WITH CAPITAL MARKET CHANGES IN ASIA PACIFIC

All these challenges come at a time when many Asia Pacific markets are transforming their clearing and settlement practices through a combination of regulatory changes, new products and technological innovation.

For instance, the Australian Stock Exchange (ASX) is powering ahead with the implementation of a Distributed Ledger Technology (DLT) replacement of its CHESS infrastructure, which is scheduled to go live in 2021. Also due to launch next year is Hong Kong Exchanges and Clearing Limited's (HKEX) DLT solution for post-trade and pre-settlement through Stock Connect. HKEX is also reviewing a potential restructure of its clearing house structure. Meanwhile, Singapore Exchange Ltd (SGX) is refining its new settlement system (SGX-PTS WEB). And India's financial regulator is implementing an interoperability solution for its own clearing house model.

Furthermore, at a time of increased volatility and evolving market structures, local regulators are reviewing existing market frameworks to ensure they are fit for purpose in terms of risk mitigation and investor safety. In such a dynamic environment, the burden on a self-clearing broker to invest in and adapt to these new infrastructure changes could easily become a substantial and a significant distraction.

Of the various options available to brokers, third-party clearing (TPC) offers clear benefits. While self-clearing may sometimes be seen as cost-effective for those managing large trading volumes, TPC can reduce capital outlays such as investing in a back-office system and hiring staff to manage the operation. In many markets, TPC is also a better choice than the legacy account-operator model as it can help reduce costs and a broker's expenses associated with direct regulatory compliance responsibility.

Consider also that securities service providers are typically at the forefront of anticipating new regulations and the impact on their clients. Brokers can count on TPC to reduce their compliance burden and help them navigate the constantly shifting maze of regulations across Asia Pacific markets. A TPC model also helps streamline clearing and settlement functions, reducing ongoing project expenditure on operations and IT, thereby freeing a broker to focus on its core business.

OPTIMISING LIQUIDITY ACROSS THE REGION

One of those core business functions is managing liquidity, which is a very different proposition in Asia than in Europe or the US. Different markets in Asia Pacific use different currencies, with different funding available in each. As such, investors selling a security in one market are required to complete an FX transaction to cover a securities trade settling in another market. This can cause a delay in funding. Similarly, brokers that operate regional hubs in Asia Pacific may need to move funds between markets to complete the timely settlement of transactions with their clients. One solution is for brokers to seek intraday liquidity solutions from their banking partners in order to cover any peak activity whilst avoiding significant fixed costs that could hit profitability.

TPC provides an alternative financial solution: the clearing party could, for instance, provide intraday liquidity solutions to a broker on an uncommitted, undisclosed basis to assist in the coverage of its daily activity. Or the clearing party could do so on a committed or overnight basis to add more certainty.

In addition, TPC can deliver significant cost savings. Costs such as capital requirements, payments of margin calls and contributions to the default fund are passed to a TPC partner. Added to which, TPC does away with the need to maintain a separate relationship with a local bank for cash settlements and liquidity requirements. In contrast, in the account operator model, a broker is responsible for all of the above except infrastructure upgrades.

ACCESS TO FUTURE DLT INFRASTRUCTURE

Adapting to the digitisation of post-trade systems - either through new technology like blockchain or the introduction of new messaging standards - can be a challenge. A third-party clearer can also provide clients with access to technological expertise, which is particularly useful in managing changes to market infrastructure.

As an example, BNP Paribas owns a stake in Digital Asset, a fintech company which has worked on both the ASX and HKEX projects mentioned above. In parallel, BNP Paribas Securities Services and Digital Asset are designing several solutions that will provide market participants with ready access to the new generation of DLT-based trading and settlement platforms. These solutions include the Corporate Action Deadline Enhancement app, which will significantly speed up the processing of corporate actions.

Even large international brokers with established self-clearing infrastructure in their home markets would be better served by outsourcing to an established third-party clearing partner in Asia Pacific. Compared with self-clearing's high fixed costs, such as capital for collateral, staffing and compliance, outsourcing the service can lead to lower and more manageable variable costs and means an international broker no longer needs to closely monitor ongoing changes in each local market.

INTERNATIONAL AND LOCAL CLEARING EXPERTISE

In essence, a TPC partner combines a broad range of financial services: custodian, settlement agent, netting provider, liquidity provider, settlement and cash bank, not to mention serving as a technology provider with guaranteed operational support.

A regional expert such as BNP Paribas Securities Services, one of the largest third-party clearers in the region, can bring a consultative approach and dedicated teams of local experts. As the region moves to implement wide-ranging changes to its market infrastructure, many of which are expected to be along the lines of those in practice in European markets, BNP Paribas Securities Services is well positioned to assist investors to make the most of the opportunities in Asia Pacific.

KEY TPC BENEFITS

- Potential to reduce capital burden on the executing broker
- Coverage of market enhancement costs by the clearing agent
- Reduced impact of peak activity (technology, capital, operational)
- Move from a fixed cost to a variable cost structure for operation and technology
- Outsource aspects of the post-trade regulatory obligation
- Centralise post-trade banking, operating and technical relationship with a single provider
- Benefit from best-in-class expertise of specialised providers
- Make use of clearing agent's innovation in areas of importance, whilst being shielded from ineffective change

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