

**PRESS RELEASE**



5 February 2002

**THE EVOLUTION TOWARDS A PAN-EUROPEAN CAPITAL MARKET HAS BEGUN**

Pen Kent, Executive Chairman, European Securities Forum, in his keynote address at the International Securities Settlement 2002 IBC Conference "Why Europe Needs Efficient Pan-European Clearing and Settlement" noted the 2005 deadline for implementing the Financial Services Action Plan.

Europe must become free of distortions of cost, regulation, or artificial internal barriers..."Europe's problem lies in cross-border costs, and in what I call complexity costs, i.e. the need to interface with multiple systems, multiple regulators, multiple legal systems, multiple pools of margin, collateral and regulatory capital. ..."The European Securities Forum has campaigned now for over two years for a horizontal structure..."Consolidation of the service providers would not eliminate all of these at a stroke. That is why the European Securities Forum has a second prong to its role – campaigning for enabling, appropriate and consistent regulation across the whole market..."

"I believe it is right for the ESF, of which I remain Executive Chairman for at least the next couple of months, to encourage support for our preferred structure. I believe the alternative will be an obstacle to the Financial Services Action Plan. I am expecting in the coming weeks more contributions to the subject from the EU Commission, the Group of Thirty, and maybe the regulators. Market forces and policy initiatives are on the march more or less hand in hand.

"The Wise Men in their Report of February 2001 wanted the market to deliver infrastructure consolidation, but failing that, possible official intervention. The importance to Europe of a super efficient capital market as part of its strategic plan for 2010 as the most competitive economy in the world cannot be exaggerated. . There is surely an individual private and a collective public interest to get there..."

A full copy of Pen Kent's address is attached.

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**Why Europe Needs Efficient Pan-European Clearing and Settlement**

**Speech by Pen Kent,**

**Executive Chairman, European Securities Forum**

**to IBC Conference "International Securities Settlement 2002"**

**5<sup>th</sup> February 2002**

**Introduction**

1. The Prime Minister of Sweden, Mr Göran Persson said in an article in the Financial Times on 14<sup>th</sup> January this year "The 2005 deadline for implementing the [Financial Services] action plan must be met". This plan, adopted at the Lisbon EU summit in March 2000, envisages the effective creation of a single, efficient capital market serving the savers and the users of capital in Europe. It is part of an even grander scheme to make Europe the world's most competitive economy by 2010.
2. The successful launch of the Euro has created an extremely important laboratory for working out how a single capital market can be created, but as you all know the EU is planning to enlarge its membership. I therefore take it for granted in what follows that the single market in financial services embraces most of Europe and not only the EU as now defined - or indeed the present eurozone.
3. This conference is concerned primarily with clearing and settlement, and you will hear in the next three days from a wide range of service providers, users and policy makers. Many like me will argue for the grand design, but many others will claim that their own firm could deliver the promised land if we would all back it. I invite you to test those claims for thinly disguised go-it-alone business plans driven by short-term shareholder value. Shareholder value is of course an entirely legitimate - some would say the only legitimate - objective for quoted companies. But sometimes the objective seen from the perspective of the individual firm looks different from the market as a whole. It is this difference which can give public policy an important role by reconciling the two. I am going to discuss aspects of this dichotomy today. Let me at the same time give myself a warning.
4. I represent many of the largest investment banks in the world. By and large they seek the same strategic goal as myself - that is an efficient pan-European capital market. But they do so of course in the interest of enhancing their own shareholder value. This is not then a tale of goodies and baddies - but of a complex interaction of many interests, usually legitimate in their own lights, but collectively evolving towards a better market.

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5. I do not suppose I am saying anything very new to you today, but I do want to give you a larger context in which to examine why we need efficient pan-European clearing and settlement.

### The Fundamentals

- 6 The European Central Bank in discussing this subject last August argued that we should no longer regard the capital markets of the eurozone as several national ones, but as a single domestic one. I entirely agree - but I would extend the boundary beyond the eurozone. The reason is simple. Major European users of capital, that is major European corporations, have virtually outgrown their home financial markets. Let me try to illustrate how.
- 7 Of the top 25 global corporations by revenue eight are from the US and nine are from the EU. The eight US corporations are a bit ahead with 40% of the total revenues compared with 32% for the nine Europeans but the difference is not huge. But when it comes to market capitalisation the story is very different. The market capitalisation of the US eight is over 3 times that of the EU nine. (Sources: revenues Fortune Global 500 for 2000; capitalisation FT Global 500 May 2001).
- 8 The total capitalisation of the North American stock exchanges was 60% higher than the whole of Europe at the end of 2000.
- 9 There are no doubt many explanatory factors at play - but this suggests to me that we in Europe are simply not in the same league. Nor do I believe we will get there until our market is genuinely pan-European, free of distortions of cost, regulation, or artificial internal barriers.
10. The buy side of the market, the institutions, which represent a large proportion of European savings are already seeking to invest in Europe - or at least the eurozone - as though it were a single market by concentrating on sectors rather than countries. In several countries there have historically been formal barriers to investment outside national frontiers. At best this has been to protect local currency assets from exchange risk, and at worst in a mistaken view that the interest of workers is best served by trapping national savings in the local economy. But institutions with their liabilities to savers denominated in Euros will be obliged to seek out the best Euro denominated stock selection wherever the stocks are issued and traded in order to remain competitive. These institutions will have little patience with barriers of cost, regulation, law, or technology, which impair performance.
11. In short I believe that market pressure from the end users on both the buy and the sell side will make inevitable the emergence of a genuine, pan-European capital market. I am not sure however exactly where its frontiers will be.

### Objectives for the Infrastructure

12. The European Securities Forum has campaigned now for over two years for a horizontal structure. In its purest form there would be three layers: at the top, multiple and competing trading platforms; a single pan-European central counterparty and netter in the middle; and a relatively small number of CSDs at the bottom. I will explore later some of the characteristics of this model. There are those who distrust it because it has an element of monopoly or because it looks too Anglo-Saxon – “not invented here”. I think those views are shortsighted and would saddle Europe with a sub optimal solution.
13. You have probably heard or read many times a description of the efficiencies and shortcomings of the horizontal model, so I will repeat them here in a sort of shorthand.

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*Trading Platforms:* *For:* competition between exchanges and other platforms likely to favour efficiency and innovation

*Against:* but would it fragment liquidity?

*Central Counterparty:* *For:* a single utility to manage post-trade risk in all security products (cash and derivative), to maximise efficient use of netting, management of margin, collateral, regulatory capital, and to secure economies of scale. Not-for-profit, majority user governance but with some exchange involvement. Not a legally enforced or protected monopoly but strong alignment of interest of both regulators and owner/users to manage risk.

*Against:* But concentration of risk (systemic?) and lack of competition stimulus.

*CSDs:* harder to consolidate for reasons of local law and local management of corporate events - but eventually consolidation into a small number - and perhaps only one to facilitate T+1 (consolidated with CCP?).

### Obstacles

14. I believe that the shortcomings can all be satisfactorily mitigated, so why is it all so difficult? The ESF has been arguing, lobbying, negotiating, designing for consolidation for over two years and we have not so far succeeded in a convincing consolidation towards a pan-European horizontal model. You probably know the obstacles as well as I do, but here are a few:-

- (a) beneficiaries of the status quo. These probably include some of my own members who successfully provide cross border custodial services. Beneficiaries also include vertical silos which typically control trading, clearing and settlement in a single ownership or control chain;
- (b) executives who fear either dilution of their own prestige or worst unemployment;
- (c) lock-in by technology;
- (d) national Statute or Regulation;
- (e) understandable fear of merger indigestion;
- (f) jealousies between financial centres or between different cultural views about how capitalism should work.

15. All of these obstacles are understandable. Very few of us in the financial sector, including myself, have a strong enough unselfish gene to sacrifice our own short term interest for someone else's long term one - or even alas our own long term one.

### Governance

16, As well as the obstacles listed above there are also some qualms about the ESF's preferred governance model. Some argue that competition is nearly always preferable to a monopoly model. Indeed I have done so myself in other contexts. But none of those who speak against a monopoly for clearing and netting have convincingly proved their case. First of all we have the real evidence of the US example – the DTCC. In the economy with the arguably the fiercest belief in unfettered market forces, the United States, the regulatory authorities actually set competition aside in the interest of investors. The authorities had to do it because the market practitioners with a vested interest in the status quo would not do so. The DTCC has mechanisms for ensuring that all users – whether they be

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shareholders in DTCC or not – get equal benefits. I am not aware that there has ever been an accusation of abuse of its monopoly. Nor am I aware of a major concern about systemic risks, although the DTCC clears and settles more volume than Europe added together. Its example has demonstrated convincingly that its model has delivered very impressive economies of scale. Furthermore by netting out 97% of volume it has relieved volume stress without which the capacity of many legacy systems in the industry would be in serious danger of falling over.

17. In a speech on 5<sup>th</sup> September 2001 Mr Padoa-Schioppa, a Member of the Executive Board of the European Central Bank, discussed the question of whether clearing and settlement were natural monopolies. He firstly identified the “positive externalities” which I have described but also looks at the negative ones. I quote: “In a monopoly situation, the lack of competition does not per se provide adequate incentives to the providers to innovate and enhance their product or service”. I agree with him but the important point is whether this problem is capable of solution. I believe it is. It is surely possible to create incentivisation regimes which incentivise management to achieve business efficiency.

18. This point is related of course to whether the resulting organisation is for-profit or not-for-profit. Some critics of the not-for-profit model rest their case on the incentivisation question. I give them the same answer as above. The weakness, which I admit, is capable of remedy and worthwhile, but with the proviso that the benefits which flow from the monopoly are significant, are equitably distributed and not offset by unacceptable levels of risk.

19. Another worry about not-for-profit models is how to reward the risk capital that underpins them. But this too can be managed satisfactorily – indeed it is done in several CSDs. The only difficult question is how to determine what that reward level should be.

20. But that said, it is apparent that fashion has moved against not-for-profit organisations which are harder to value in the eyes of the market and difficult to consolidate with for-profit firms. I myself reject the argument that these are showstoppers for potential consolidation in the European infrastructure today.

21. I also agree with the ECB that we all have to be satisfied about the identification and containment of systematic risk. Let us look at a table, which shows which parties have the greatest stake either in maximisation of profit or in maximum rigour in risk management of a central counterparty:

	Maximisation Of Profit	Not for Profit Maximum Rigour In Risk Management
Independent shareholders	✓	X
Investors	X	✓
Users	X	✓
Regulators	X	✓
Central banks / lenders of last resort	X	✓

You may or may not accept this description, but it does show the maximum alignment of most interests for the not-for-profit model.

22. And would the advocates of the principle of competition prefer to keep the pan-European capital market segmented for the sake of that principle? If segmentation were valid in the whole of Europe, why would it not also be in the domestic market e.g. the USA or the eurozone?.

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23. But Mr. Pado-Schioppa does not make his arguments absolute and nor do I. If we shared the need to sort out this question of governance and rigour of risk management in a mutually acceptable way I believe we could do it. I still think that the onus of proof lies with those who do not accept the DTCC lesson of history.

### Costs

24. My opponents quite often seek to defuse the question of high costs in Europe by pointing out that our domestic transactions costs are in many cases among the lowest in the world. True, I say, but not relevant. Europe's problem lies in cross-border costs, and in what I call complexity costs, i.e. the need to interface with multiple systems, multiple regulators, multiple legal systems, multiple pools of margin, collateral and regulatory capital. Consolidation of the service providers would not eliminate all of these at a stroke. That is why the European Securities Forum has a second prong to its role – campaigning for enabling, appropriate and consistent regulation across the whole market.

### Interoperability

25. If we cannot get consolidation will interoperability do? Is it a cop out or a solution? The answer is that it could be either – and would depend how it is done. Interoperability will be one of this year's most overused words. It is the defensive fig leaf of those who do not want to consolidate but know they are under pressure from the goal of the single market in financial services.

26. But it is also a route to open architecture of competing infrastructures. That would then allow market forces the true freedom of expression to choose the infrastructure of their choice.

### Recent Developments

27. Let us do a reality check on where we are. Is there any prospect of getting to a horizontal structure after the IPOs of Deutsche Börse and Euronext, and the listing of the London Stock Exchange? I still think the answer is "yes" – but at the beginning it may be partial, not pan-European. What follows is based on my observations and not on any inside knowledge. This is not the place to give you an inside track even if I had one.

28. Clearnet which clears for the Euronext family and is currently 100% owned by Euronext has spoken publicly about amending its ownership and governance to share them between exchanges and users. Euroclear is relatively independent of the Euronext but settles for it. Euronext has a bridge to the London market through LIFFE which is a part owner of the London Clearing House. The London Stock Exchange which is a supporter of the horizontal model has announced its intention to offer Euroclear to users as an alternative to CREST for settlement. We have the potential here of relatively open architecture, with a clear horizontal shape, albeit not at its most pure. Two of my leading members have recently demonstrated their believe in this evolution by moving assets to Euroclear from Clearstream.

29. At the time of writing the Deutsche Börse bid for Clearstream has been put on the table but awaits the vote of those who must accept the bid for it to be finalised. If Deutsche Börse is successful which looks like the presumption at this time, Europe will be crystallising into two or three major models – one a de facto silo, one a purely horizontal structure, and the third moving by steps from the vertical camp to the horizontal one. I believe the alternative will be an obstacle to the delivery of the Financial Services Action Plan. I believe it is right for the ESF, of which I remain

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Executive Chairman for at least the next couple of months, to encourage support for our preferred structure. I am expecting in the coming weeks more contributions to the subject from the EU Commission, the Group of Thirty, and may be the regulators. Market forces and policy initiatives are on the march more or less hand in hand.

### Conclusion

30. My members and others did not seize the high ground earlier with enough determination. Since then the going has got harder, not easier. After a number of setbacks to the ambitions of the ESF there is now real scope for evolution in the right direction. The Wise Men in their Report of February 2001 wanted the market to deliver infrastructure consolidation, but failing that, possible official intervention. The importance to Europe of a super efficient capital market as part of its strategic plan for 2010 as the most competitive economy in the world cannot be exaggerated. There is surely an individual private and a collective public interest to get there. I am trying to help us do so. I hope what you hear at this conference tells you whether we are travelling fast enough. If you think the answer is "no" I encourage you all to say so from the floor.

### Pen Kent

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