

PRESS RELEASE

10 November 2000



Changes in Market Structure

Central Counterparties and Settlement Risk Reduction

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The birth of a pan European Capital market

I believe that the fundamentals of the European markets are inexorably driving towards a pan-European capital market. The difficult question is whether this process will be orderly or not; painful or not; efficient or not.

First of all the capital needs of the larger European corporations are outgrowing their traditional sources. There was a time when many of them relied upon their domestic banking system, but they can no longer do so. Many of them have better credit ratings than their lead banks and therefore raise capital more cheaply. Furthermore the lead banks can no longer accept the concentration of exposure to such major borrowers. These need to raise capital at the lowest cost in the most liquid market. Indeed some are already turning to the North American market for that reason. In Europe, and most particularly in Euroland, the issuers of capital are becoming more and more blind to national frontiers.

Second are the investors themselves. The ageing population of Europe will generate a massive growth in collective funds. Most of the liabilities of the funds will be in euros and so will be most of their assets. In this way a tidal wave of investment funds will be

generated which will not be satisfied only with national markets. Many of them will be indexed to pan-European performance, and they will exert steady pressure on governments, regulators, and market structures to remove barriers to pan-European investment, whether those barriers are ones of price; or administrative obstacles; or of statutory straight-jackets.

In my judgement the momentum will continue to build for all these reasons. The EU governments share this expectation. The EU summit in March 2000 in Lisbon spoke of "the central role of efficient financial markets for long-term European competitiveness". The EU Commission said later in a Progress Report on Financial Services "Integrated European capital markets are essential for sustained growth and employment". The European Council has set 2005 as the target for achievement of this goal. But the

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Council lacks the means of realising the goal. Only the markets can do that. The Council does however have potentially a powerful leadership role in the removal of impediments.

I recognise that national markets for raising capital and for trading the shares of smaller companies are likely to be needed for a long time. There will continue to be many investors and many intermediaries who will meet that need. In any event there will be horses for courses – the important thing is that users can choose. I want a pan-European market to be regarded not as a threat but as an opportunity for wider choice.

I suppose I do not need to make macro-economic case. Europe will only be able to compete in global markets and so provide employment, if it can encourage competitive levels of capital formation. Access to deep and liquid capital markets – both primary and secondary – is surely a necessary precondition.

Technology

Technology often gets the credit for the structural changes we are discussing. There is no doubt that it is a powerful enabling force. It has increased competition by reducing the cost of entry into serving markets. It has potentially freed users, servers and intermediaries from the prison of local or national monopolies. But I suggest that technology has not yet delivered total freedom, nor is it the primary cause of so much change. I could of course be quite wrong, but I still attach more weight to the fundamentals I have described.

Defining Europe

What I am about to say about the boundaries to Europe may seem to contradict what I have said about technology. Modern technology can certainly mean an end to geography. Remote trading and post-trade processing reduce the significance of geographical or economic boundaries. It is possible that regulation can act as a net to capture business for a nation. But I doubt even that. In a world of free capital

movements financial markets will naturally flow to the most favourable environment. So Europe cannot in the long run be artificially constrained to mean only euroland, or only the EU. It includes rather all the relatively mature market economies that the market is ready to embrace. But if distortions drive the markets artificially to less efficient channels, or channels which lack transparency and proper regulation, there will still be avoidable costs to bear. Remember we have already seen a massive relocation of markets historically when regulations blocked the normal channels. That was of course the creation of the euro \$ market long before we all had the web, email and mobiles.

Regulation

Unfortunately regulation will continue to add to cost and complexity. The iX debate showed how difficult it can be to harmonise the regulatory regime for cross border enterprise. The appointment of the Wise Men by the EU governments to make recommendations about the future of regulation in the Community is a recognition that regulation could be the slowest ship in the convoy. Some of this reflects deliberate

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attempts to influence the location of business, but it also flows from the sheer length of the legislative process in most countries, so that enabling changes lag far behind sensible market reforms. I hope that the Wise Men whose interim report is expected about now will nevertheless identify the obstacles and point to ways to remove them.

Stock Exchanges

Before I get to the role of the European Securities Forum in relation to clearing, netting and settlement, I want to say a bit about Stock Exchanges. Exchanges everywhere are huge, very important, but nevertheless in fear of their lives. Like all threatened species they are huddling together for protection. We see about us mergers of cash exchanges in different centres, and mergers which bring together cash and derivatives. This process is starting to shake loose the old vertical silos, which combine trading, clearing and settlement, usually but not always dominated by the trading interests. This provides a major opportunity to restructure the industry.

This flurry of cross border mergers can be interpreted either as a defense move by national exchanges to defend their franchise or as the seizing of opportunities to follow the market forces I have already described. Perhaps the answer is a bit of both. In any event alternative trading platforms are also emerging to challenge traditional stock exchanges. Some very eminent statesmen in the financial sector have entered a note of caution about a risk to liquidity which could arise in this environment.

There is an interesting debate in the market about what generates liquidity. I wish I knew the answer myself. It could help guide our own policy. One school believes that liquidity is a kind of aura around stock exchanges generated by the concentration of order flows.

Indeed there have been several attempts in the past to make such concentration a regulatory requirement, in considerable part for this very reason. But there have also been I believe other, less noble, protectionist motives for this argument.

The second school also contains an element of special pleading. It says that the "concentration" benefits are already captured by the sheer size of the big investment banks and that they have the power to locate the liquidity anywhere or nowhere by their choice of trading infrastructure. I am inclined to believe that the truth lies somewhere between the two. There are powerful arguments in favour of concentration – price formation, transparency, best execution – but no stock exchange has a monopoly right to such concentration. Nor do they have the right to use concentration as a device to capture clearing and settlement.

The collapse of the iX project has undoubtedly been a setback to progress, but I hope this is only temporary. I will do my best to ensure that it is. We are in the eye of a storm of change at the trading platform level, and understandably all parties are battenning down the hatches until the view of the landscape clears.

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The European Securities Forum

Before this juncture the wholesale market had already decided to act. It founded the European Securities Industry Users Group to squeeze out costs. We have since changed the name of the Group to the European Securities Forum ("ESF") for no profound reason except it sounds better.

The membership of the ESF is genuinely representative – we have firms from every one of the Group of Ten countries except Canada. I detect no differences of vision arising from nationality or location. If there is any split, it is between those who genuinely believe that a pan European capital market without barriers is inevitable and desirable, and those who still take a more national view of self-interest.

The ESF has simple goals. They are:

1. To restructure the vertical silos into independent, separate horizontal layers i.e. trading; clearing and netting in a central counterparty; and settlement.
2. To create a single pan European central counterparty ("CCP") for all securities (equities, fixed income, derivatives and over the counter).
3. To reduce the number of settlement systems (International Central Securities Depositories and the national CSDs).

Our own priorities are progress on the central counterparty and on settlement. That is where there is most duplication of function and of capital expenditure. Costs per transaction fall dramatically with sheer volume and the fastest way to achieve that is by consolidation. The market believes that 80% of the difference between cross border transactions in Europe and domestic transactions in the USA can be eliminated in this way. The quick and important wins are here. Some argue that the comparison between

cross-border and domestic is unfair. 20 years ago it would have been. 20 months from now the label cross-border should be redundant in this market.

Our ideal is to persuade the existing providers of CCP to come together into a single service. We have already had discussions with most of them and they accept the broad concept.

Our preferred plan is to restructure them so that there is a single strategic governance and a single technical development plan in place of three or more. The precise corporate structure is not important but the result must pass the following tests:

1. The wholesale market can concentrate all its clearing and netting into one entity. This will create a massive economy of administration, and of management of risk.
2. The users will have a majority voice in the ownership and governance of the service as a whole.
3. Tariffs will be set to reflect the cost of the service. This will mean an end of subsidies to other market functions like trading platforms. Risk capital will be remunerated. Whether all or part of the corporate structure is "for profit" or "not for profit" has still not been decided, but our preference is for "not for profit" at least for most of it. This is not a matter of doctrine, but we think that regulation of a "for-profit" organisation would be difficult, thorny, and hard to agree with the regulators.

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4. The use of the service, or perhaps parts of the service, will be voluntary. The private client brokers for example should not in principle be required to use functions, which give them no added value. We are sensitive to this issue. I cannot give an absolute guarantee, but I promise our best endeavours. If we succeed in cutting out cost all users would surely benefit and be able to offer their own clients more choice at less cost.

I have already mentioned the setback to progress from the iX deal. We were compelled to recognise that the early promise of progress with the existing service providers was disappointed. The ESF has accordingly agreed to regroup around a quick action group who were already planning against this possibility. They are a sub group of membership. We have called this approach for convenience, "Plan B". Under our first approach which I have already discussed we deliberately gave the initiative to the service providers to offer the solution. Plan B keeps the initiative with us. We are planning within weeks to issue a blueprint of a pan-European CCP and a request for proposals ("RFP"). We do not of course know who will respond to that. Our first preference is still a pan-European approach from the existing service providers. But if after all they are not willing, we will contemplate a genuine, go-it-alone, greenfield development. I know that this raises many hurdles to overcome, but our readiness to contemplate it is a mark of our impatience to make a breakthrough.

Where will the CCP be located?

I do not know yet. The CCP may want to preserve some local functionality in each country. At first blush this might suit domestic retail business. This could dilute the purity of our vision, but may nevertheless be a realistic and acceptable recognition of local interests provided that the acceptability tests can be passed - the essentials will not be sacrificed. What is clear is that our ideal must satisfy many regulators including some not in the EU.

Risk Reduction

In an oversimplified description of the European market there are, say, five separate products in fifteen separate countries, i.e. 75 different pockets of collateral. Anyone familiar with portfolio theory will recognise that this is not an efficient structure. If all the pockets are aggregated into one CCP, the portfolio effect and the management efficiency gain could save millions of risk capital. I regret that I cannot give you a good calculation of this saving. This is partly because large parts of the European market have hitherto managed without a CCP. They will not be able to do so in future. This is partly for reasons of sheer scale. Many firms IT systems are working well above designed volumes. There is thus a real risk of collapse from overload. This is the so-called scaling problem. Netting which a CCP can deliver helps to deal with scale by reducing the actual value and number of deals to be settled net. But that is for the future. For the past I do not have a "before and after" measure to tell you the scale of economies promised by a CCP. All I can say is that logically they must run into billions of any unit you care to use. There are

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also on top of that economies of scale, of reduced capital expenditure and of overhead which we believe would quickly take 1bn euro out of annual transactions costs.

The average cost of transactions across Europe is between 10 and 20 times that of the US. This is a serious barrier to the creation of a genuine, pan European capital market. This cost burden reflects the patchwork quilt of national exchanges with their mix of clearing and settlement infrastructures. The only way to eliminate this burden is to simplify the infrastructure radically, get rid of duplicate costs, economise on regulatory capital, and capture massive economies of scale.

Unfortunately not all the effects are benign. The economies would be offset to some extent by the concentration of risk. This risk could of course be mitigated by adequate default arrangements. Could we imagine a global market with only, say, three major central counterparties, probably in Europe, North America, and the Pacific Basin. Could they provide back up for each other? I believe so. DTCC has recently issued a White Paper, which looks forward to a truly global market infrastructure. Whatever happens in Europe next we need to remember not to make it so parochial that it is disabled from a truly global role.

I cannot give you precise answers now how our evolution will change the size and nature of risk – or indeed the nature of its regulation. Indeed the regulators have asked the ESF to help with the analytical work to determine whether the risk characteristics of a single CCP are a mathematical compilation of those of the separate pockets or whether they differ in some qualitative or quantitative way. The ESF has formed a Regulation Working Group, which will include risk experts from ESF member firms, the service providers and the regulators. In that we hope to develop quickly a common understanding of the issues, and to propose regulatory solutions.

Of course many of the major international users of the CCP will have a very large exposure to it, and they will want to protect themselves fully from corresponding risks. I do not expect therefore that the demand for rigour will be any the less from the market than from the regulators themselves. Indeed the regulators might take comfort if they are satisfied that the market has adopted a degree of self-policing. I believe that this way of designing effective regulation can help both regulators and the market alike. The ESF has given itself short, sharp targets for infrastructure change. If it were to have a long-term role it could well be as a partner to help the evolution of regulation.

I should say something about the governance of a single CCP. It will, of course, be a monopoly. History does not on the whole encourage us to believe that monopolies can remain entrepreneurial and efficient. I fully accept that, and I accept much of the argument in principle for competition and for profit making institutions. However, for a single CCP the gains are, we believe, so great that they justify the monopoly route. We also suppose that the regulators would have more difficulty with a monopoly if it were for profit.

Settlement

In parallel with our work on a CCP we are trying to simplify the settlement infrastructure. This means mergers. There are over 20 settlement bodies in Europe. We doubt that there is really room or need for more than two or three. I do not have a detailed blueprint, which would determine the future of all these, but we are working on a road map for progress.

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Of course there continues to be risk at the end of the chain i.e. settlement. The biggest economies would flow from eliminating fails, and from good management of corporate events. I am inclined to think that a different governance model would probably best obtain these efficiency gains, retaining a competitive element probably driven by a profit motive. But there is more than one way of incentivising management and there are in my view some very effective models of settlement utilities. The ESF is much less prescriptive on the details of settlement consolidation than it is on a CCP.

If Europe is to move quickly towards T+1 for settlement cycles, we may have to reconsider the ownership and governance relationships between a CCP and CSD – as they have in the USA where the DTCC and the NSCC are coming under one umbrella –

but our market in Europe is less mature and therefore less ripe for it. I do not rule it out – but let us get the rest right first!

Conclusion

Many market participants have a strong vested interest in market inefficiencies because they have a competitive advantage in exploiting them. Many institutions have a vested interest in maintaining the status quo in clearing and settlement. This is entirely natural and understandable. It takes magnanimity and self-confidence to put energy into rationalisation that will greatly increase global welfare but apparently diminishes your own. I recognise that. But unless we make progress quickly we will keep too high the risks of transacting in Europe and therefore the costs. The existing service providers continue to invest in major projects which frankly duplicate what is already available. Much of this cost could be saved. What continues to happen right now in clearing and settlement is adding to Europe’s competitive disadvantage. Surely this is short sighted. It reflects exploitation of captive markets. Unless we can stop it and reverse it, it will threaten the employment of our grandchildren, if not of our own generation. We do have to believe in the theory of the unselfish gene – i.e. in the instinct to make personal sacrifices, which will benefit all our futures. This is not an internal fight about who provides the back office. This is an important issue about prosperity in Europe. It is time for everyone to realise that and support the cause.

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