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Committee of European Securities Regulators
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France

Elias Kazarian
European Central Bank
Kaiserstrasse 29
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Germany

Dear Sirs,

Contribution from the London Clearing House to the joint work of CESR and ECB in the field of clearing and settlement

The London Clearing House (LCH), whose central counterparty clearing activities are explained in the attached summary, welcomes the opportunity to contribute to the work of CESR-ECB. We understand that consideration of central counterparty clearing is at a relatively early stage and look forward to further, more detailed dialogue over the course of the year.

Our comments follow the order of the general questions raised in the CESR-ECB paper of 15 March :

2.1 Nature of the recommendations and
2.2 Addressee of standards or recommendations

LCH's earlier comments to the European Commission, the 'Wise Men' and others involved in the debate on further integration of the capital markets in Europe took the view : that operational and risk management standards amongst central counterparty clearing houses in Europe were relatively uniform ; that 'cross-border' clearing activity of various kinds was possible under current, largely national regulatory arrangements, supplemented by closer co-operation between national regulators ; and that therefore no EU-level initiative was required. These comments *ante-dated* the CESR-ECB work, which we believe was principally motivated by CPSS-IOSCO co-operation rather than 'single market' considerations.

Our view has changed somewhat over the past year or so. Although 'cross-border' clearing activity *is* possible under current regulatory arrangements in Europe, our experience is that there may be constraints in the absence of EU-level standards. As CESR-ECB has embarked on the task of establishing recommendations or standards, those recommendations or standards could serve as the basis for an EU directive or regulation.[1] That would establish the harmonisation necessary to remove national regulatory 'glue' to genuine cross-border clearing and enable consequential modification of the Investment Services Directive to provide a 'passport' for central counterparty clearing houses.

Whilst our experience of trying to broaden our range of clearing inclines us now to favour standards or recommendations addressed to the European Commission and legislators, we would emphasise that it is clearly those bodies rather than CESR-ECB that are charged with initiation and adoption of legislation in the European Union, and note from CESR-ECB's paper that it anticipates the provision of input to the Commission "on the form of intervention that may be needed in this area".

2.3 Scope of CESR-ECB work : functional approach

We interpret the inter-related questions addressed under this heading as a general enquiry on whether we agree with what is now commonly described as the 'functional approach' to regulatory standards.

In general terms, how can we disagree with the concept of equal treatment for all 'financial institutions' undertaking comparable activities ?

But to be more specific, we would note that the stronger opinions on this subject come from CSDs and ICSDs and also from exchange owners of clearing houses that believe themselves to be in competition with their major participants and users. Our perspective is rather that we have a complementary relationship, in terms of risk management, with participants (clearing members). The fact that those participants manage client risk that could, in certain clearing models, be managed directly by the clearing house is for us a welcome and beneficial division of labour and diversification of systemic risk. If the capital or other regulatory requirements established for certain participants/clearing members are deficient – and would be 'lifted' by a functional approach' – we are in favour of such elevation. But we are not aware of such deficiencies.

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[1] We note some uncertainty on the part of CESR-ECB as to whether it will or will not issue recommendations and/or standards. Question 2.1 leaves no doubt as to the firm intention to do so ; Question 2.2 refers to "the possible standards or recommendations to be drawn up by the Group".

2.4 Objectives

It is most welcome to be asked for comment on what public policy objectives should be. Often they are simply handed down, *ex cathedra*. We are appreciative of this enlightened approach.

The policy objectives seem to us perhaps to be too ambitious. Usually ambition is totally laudable. In this instance, over-ambition could lead to confusion of purpose. We do not , for example, understand the prominence given to the third objective – "creation of a level playing-field between participants and service providers" – which we interpret as the 'functional approach' rationale. It seems to us that this objective is a secondary one that should come into play only if the playing-field is so uneven as to frustrate the core public policy objectives of risk mitigation and investor protection (your first objective). We would add that measurement of the evenness of the playing-field is in any event problematic, so a less absolute objective would seem appropriate.

Our other observation on the public policy objectives is that the first and core objective – risk mitigation and investor protection – is totally shared as a 'private' objective by central counterparty clearing houses. One could, indeed, dispute rights to ownership in respect of risk mitigation! Certainly the techniques of risk mitigation used by central counterparty clearing houses were developed by them rather than by securities regulators or central banks. Equally, though, there is no dispute as to who is responsible for supervisory oversight in conformity with public policy objectives.

2.5 Access conditions

Central counterparty clearing houses 'interact' with both securities settlement systems and with money payment systems. To offer a broad 'European' or international service in a range of instruments, as opposed to an essentially domestic service in terms of cash securities, clearing houses need broad access to such systems. Currently a number of different access requirements apply. It is hard to describe them as exactly discriminatory but they were conceived on a national plane and typically designed around domestic institutions.

Direct access to domestic securities settlement systems by clearing houses should be facilitated by clear, transparent, non-discriminatory criteria.

2.6 Risks and weaknesses

We feel that the distinction made in the questions between domestic and cross-border transactions draws heavily on the securities settlement/CSD discussions and that the essence of central counterparty clearing activity is that it largely removes such distinctions. It seems important to us that CESR-ECB should try to analyse and define 'cross-border' in

the clearing context and appreciate its extent, even in the current conjuncture. For example (and the list is selective) :

1. 'cross-border' product clearing

country of 'origin'	product	country of clearing
Finland	Options on Nokia shares	Germany (Switzerland) by Eurex Clearing
'Euroland'	Euribor futures and options	UK by LCH
Germany	Repos on German government bonds	UK by LCH & France by Clearnet (inactive)
Austria) Belgium) Netherlands)	Repos on government bonds	UK by LCH

2. 'cross-border' market clearing

country of origin	market	country of clearing
Belgium	Exchange market in Belgian shares and futures and options	))) France by Clearnet
Netherlands	Exchange market in Dutch shares and futures and options	))

Explanation : the markets that fused into the Euronext group were uniquely domestic in product scope but have opted for common clearing organised under French law by a French company.

UK	Coredeal – electronic market in European corporate bonds	Belgium by Euroclear

3. 'cross-border' clearing membership / participation

Many European clearing houses accept both legally and geographically remote participants (for example, Clearnet and LCH).

We believe that there is a tendency significantly to exaggerate cross-border risk and that such exaggeration can be used as a barrier to the integration and greater efficiency of European markets. In specific relationship to clearing houses, the reinforcement of domestic insolvency protection by the European dimension of the Settlement Finality Directive has been most helpful.

2.7 Settlement cycles

Clearing houses operate in accordance with, and can adapt to changes in, various settlement cycles. The inter-connection is, of course, of most significance where an equity or bond market has adopted a central counterparty model. In such cases all trades result (typically after netting) in delivery versus payment settlement organised by a CSD/ICSD, with the clearing house as a ubiquitous counterparty. At one level, clearing houses are indifferent to the harmonisation or shortening of securities settlement cycles, because they can adapt to them. On the other hand, it is pertinent to observe that central counterparty clearing arrangements might be thought to remove much of the need to seek further shortening of securities settlement cycles in Europe, because of the risk mitigation and certainty that they provide.

2.8 Structural issues

If the public policy objectives set out in section 2.4 are accepted as correct, then the grounds for intervention to re-structure clearing and settlement arrangements, or to require certain governance arrangements, will exist if current structures frustrate attainment of the public policy objectives. It should be possible *a priori* to assess the impact on those objective of the different structural models that you refer to as centralised and de-centralised.

It is important initially to define what is understood by centralised and de-centralised structures, as the terms can be used, logically, in different ways, depending upon whether the reference point is clearing or ownership models. LCH takes a clearing perspective and uses centralised to mean the clearing of more than one market (exchange or non-exchange) by one clearing house. This is more usually described as the horizontal model. The opposite, a de-centralised structure in your terms, is one in which one market or group of connected markets is cleared by one clearing house. This is often referred to as the vertical model. It is typically the case that in de-centralised/vertical clearing structures there is exchange ownership and control of clearing (Deutsche Börse has gone one step further and taken ownership of settlement facilities); and that in centralised/horizontal clearing structures there is ownership by participants and exchanges. The main clearing structures in Europe, using these definitions, are shown below :

Type	**Name**	**Ownership**	**Markets cleared**
Centralised / horizontal	LCH	75% members / 25% exchanges	LIFFE, LME, ICE IPE, London Stock Exchange ; ATSs ; OTC

De-centralised / vertical :			
model (a)	Clearnet	80% Euronext / 20% Euroclear	Euronext ; ATSs
model (b)	Eurex Clearing	50% Deutsche Börse / 50% SWX (Swiss Exchange)	Eurex

We do not believe that either model would require public intervention on grounds of it representing a threat to systemic stability or investor protection. The centralised model has theoretical advantages in terms of independence of risk management and we are aware that regulators and central bankers have focused on potential conflicts of interest for profit maximising, de-mutualised exchanges – would they be tempted to economise on risk management in order to increase turnover and profits? But we do not hold such academic arguments in high regard and they do not accord with observed behaviour.

The 'level playing field between participants and infrastructure providers' policy objective does not seem relevant in consideration of possible intervention to change organisational models or governance arrangements of clearing houses.

Grounds for potential intervention would seem to us to lie in the frustration of the stated objectives of enhancing efficiency and the integration of European markets, but notably the latter. De-centralised/vertical structures can increase efficiency in the short to medium term, and Deutsche Börse's case for its trading to settlement conglomerate is based, with some justification, on economies of scale and efficiencies of processing. The weakness of de-centralised/vertical structures lies in terms of their scope of clearing (instrument coverage) : if the exchange owner's trading arrangements do not cover particular instruments, or if they have failed to develop liquidity in particular instruments, the market-place will be denied the economies and efficiencies that centralised (horizontal) clearing can offer. One assumes that the goal of a de-centralised clearing house is, ultimately, to become a centralised one, via complete dominance of trading and clearing (and in some cases settlement). The same holds if the de-centralised clearing house is owned by an exchange group which is the sole or overwhelming source of cleared trades.

This argumentation leads to the final question posed – are CCPs, CSDs, ICSDs and "providers of trading services .. to be regarded as commercial firms, or should they be considered as utilities" ? Our first observation is that most of the "infrastructure and service providers" to which you refer are, in Europe, now organised as commercial firms or companies, whether listed or not. This contrasts with the position in the United States, although de-mutualisation has occurred in other parts of the world. Our second observation

is that all the evidence suggests that trading liquidity concentrates and that the extent of real competition is extremely limited. This is demonstrably the case with exchange trading : in which the sole example of liquidity transference (German government bond futures and options) was attributable to LIFFE's mistake - resistance to electronic trading - as much as to Deutsche Börse's efforts. It might appear that ATS-based bond and repo trading defies the concentration theory ; but that is because the electronic markets are in the early stages of replacing bilateral and brokered trading – concentration is in the wings. Our third observation is that exchanges and ATSs are the sole arbiters of where and how the contracts negotiated on their facilities are cleared. So, suppliers of largely monopolistic trading facilities who are increasingly organised as profit-maximising companies have even more monopolistic control over the clearing of 'their' contracts.

There would seem, on the basis of this argumentation, to be a case for treating both exchanges and ATSs as utilities ; with the emphasis on the regulation of pricing at all levels controlled by them, which in some cases extends through clearing (CCP) to settlement at CSD/ICSD level. The case for regarding CCPs as utilities is that, if they operate on the horizontal plane (centralised model) and clear for a very broad range of competing exchanges – as occurs on a product basis in the United States – they are a monopoly provider and should not extract monopolistic rents. The difficulty is that, unless such a horizontal model can be 'mandated' – as it was, effectively, by the SEC and the brokerage community in the US – any CCP acting as a utility in terms of pricing is financially weak in comparison with a for-profit exchange group with captive, in-house clearing.

Yours faithfully,

A M Lamb
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& Deputy Chief Executive