

Consolidation of post-trade securities processing or concentration of risk?

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reGEN

Overview

- London at Big Bang
- Consolidation
 - Vertical integration
 - Horizontal integration
- Compare consolidation initiatives
- Culture and governance
- ISSA recommendations 2000
- Define and form conclusions
 - Securities
 - Convergence/consolidation
 - Governance
 - Vertical vs. horizontal integration
- Discussion scenario

London Stock Exchange at 'Big Bang'

- Competent Authority for listing
- Trading provided on floor and on screen
- Responsible for UK equities, international equities, traded options, traditional options and UK and Irish gilts trading
- Settlement via Talisman and INS
- Self-regulated (a division of the exchange)
- Provider of market-price dissemination
- Provider of company news

The perfect vertically integrated market

**Since the 'Big Bang' progressively unbundled
The UK market is horizontally integrated**

Consolidation

Consolidation process moving in two directions

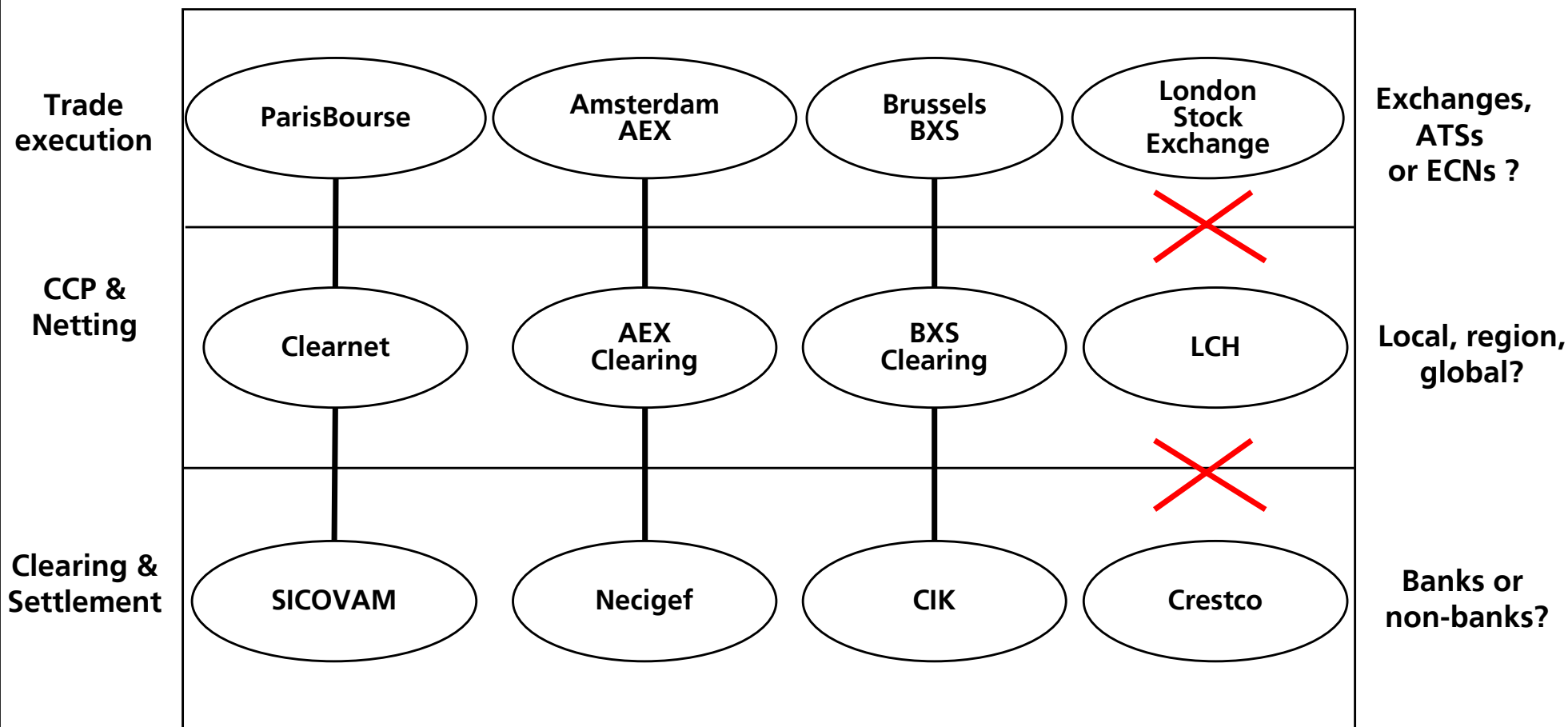
- Vertical integration
 - the securities trading, clearing, settlement and safekeeping utilities become increasingly integrated
 - New governance - holding and subsidiary companies
 - New entity provides single organisation/system for debt and equities, traded on spot/derivatives markets.
- Horizontal integration
 - The Anglo-Saxon model resulting from the London 'Big-Bang'
 - The cross-border integration (or cooperation between) institutions providing similar services e.g. on-exchange trading, clearing and CCP, settlement, etc.

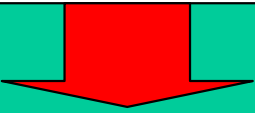
Consolidation implications

- Both forms of integration can be viewed as being positive - reduction of duplication
- Vertical integration allows for full integration across all key processes of the investment cycle
- Horizontal integration provides for economies of scale in separate processes in commercial, market owned or user governed utilities

Vertical integration nationally makes horizontal integration progressively more difficult on a pan-European level

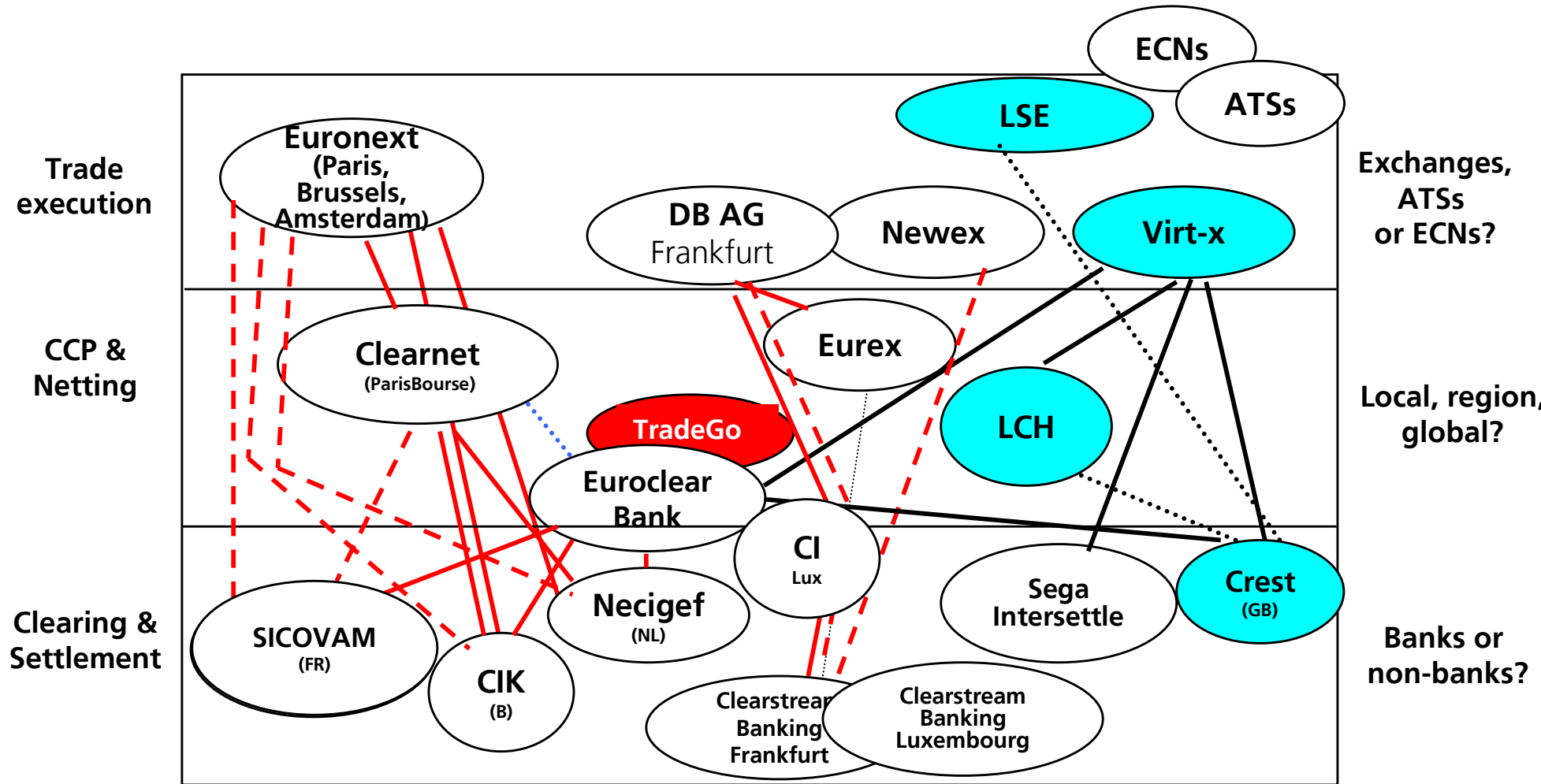
Vertical versus horizontal integration




 Vertically integrated by relationship

=
 Horizontally integrated

Consolidation vs. competition?



Nasdaq Europe?

Notes

- Ownership
- - - Exclusive arrangements
- Relationship
- · · Option

Culture and governance

Trade execution	Mutual Self financing	Regulated Demutualised For profit	Regulated ECN/ATS For profit	Unregulated ECN/ATS For profit	Exchanges or ECNs ?
CCP & Netting	Regulated National utilities Market owned, user governed Not for profit		Heavily regulated Service providers Market owned, user governed For profit		Local, regional or global?
Clearing & Settlement	Regulated National utilities CSD combines Market owned, user governed Self financing		Regulated Agent Banks For profit	Unregulated B2B	Banks or non-banks?

ISSA 2000 recommendations

- Comprehensive
- Logical
- Makes a positive contribution
- **Unfortunate timing!**
- Capital markets comparable to a European Grand Prix
 - Competing national teams which need to cooperate
 - Rules and standards (harmonised)
 - Regulatory body (singular)
 - Technology is key – investments high and high risk
 - Benefits: return on investment/prestige
 - Risks
 - Stakes are high
 - Human error and casualties

Speed increases risk – ‘proceed in haste, repent at leisure’

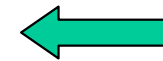
ISSA 2000 recommendations

Goals

- Sound **governance** and equitable treatment of all
- **Robust and scaleable** IT platforms
- **User friendly** communications
- Operation **risk** reduction
- **Compliance** with local regulation and equitable treatment of all investors
- Investor **protection**
- **User focused** infrastructural change
- Clear securities **laws** in all countries
- Cost
- Efficiency
- Real time
- DVP
- Rules
- Securities/debt/equity
- Convergence/consolidation

Number

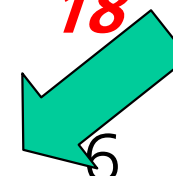
7



1 + 1

0

18



6

9

0

23

11

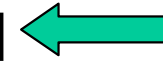
2

17

1

21

17 + 2 + 1



4



Investment ZERO

ISSA 2000 recommendations

Key points and issues

- Difficult to disagree with recommendations
- In line with market sentiment and current thinking
- May suffer from political correctness!
- Shortcomings inevitable
- Define and form conclusions
 - Business case – Investment vs. savings
 - Governance
 - Vertical vs. horizontal integration
 - Securities
 - Convergence/consolidation
- Discussion scenario

Business case – Define

- Equities - different products & suppliers to bonds
- Cost and risk reduction, efficiency - all different
- Investment needed to reduce costs, improve efficiency and reduce risk
- Mergers lead to shared investment and risk and overhead cost reductions
- Mergers are disruptive, politically sensitive and could give rise to increased operational risk
- Mergers prone to failure
- Integration of organisations is expensive (legal, consultancy, redundancy)
- IT systems integration in high volume transaction banking processing is expensive and high risk

Business case – Conclusion

- We have no idea
 - of investment needs
 - of cost or impact of cost reduction
- We cannot
 - Assess cost benefits of reductions in risk vs. impact on liquidity - and business volumes
 - Assess benefit of changes in laws/regulations/standards/harmonised market practices
 - Compare the cost differences between bonds and equity processing
- ICSD and CSD comparison - fundamental difference in product/service structures – and cost
- The cost benefits of cross-margining are unknown

We have no business case

At best we have an act of faith

Governance - Define

- Organisations (exchanges, CCP, ICSDs/CSDs) -high investment needs - can be fully commercial
- Competitive environment
- For-profits motivated – *even if*
 - Role is in risk management and/or in a dominant position: *because*
 - If appropriately regulated; cannot abuse their position.
- Similarly, such organisations can be cooperatives or market owned and user governed
- Need not be for-profits (self-financing) - and
 - Role is in risk management and/or in a dominant position
 - If appropriately regulated; cannot abuse their position.

Governance - Conclusion

The market and regulatory bodies should

- *focus on the benefits to be achieved from effective governance*, rather than
- *arbitrarily pressing the case for one form of corporate structure over another.*

In consolidating markets, the central organisations

- *free to choose which structure best meets their needs.*

This is favoured over regulatory intervention.

Vertical vs. horizontal integration - Define

- 'Vertical Silos'
 - emerged as appropriate solutions for efficient national markets.
 - When required to deregulate compete (the Passport) 'Vertical Silos' perceived as providing members/ customers with exclusive arrangements and/or, restricting access rights.
- The London market (International role - Forex, insurance, commodities, the Euromarket) - many international financial - horizontally integrated
 - London deregulation provided equal status/ access rights to foreign financial institutions
 - Resulted in the unbundling of the London Stock Exchange (as a 'Vertical Silo')

Vertical vs. horizontal integration - Conclusion

From the historic perspective:

A ***horizontally*** integrated European solution appears to be both ***appropriate and desirable for the creation of an integrated EU internal securities market.***

Securities - Define

The market situation

- We're *not talking about* efficiency, cost and risks associated with *securities* processing.
- We *are talking about* efficiency, cost and risks associated with *debt* and *equity* instrument processing

Securities - Define

Debt

- Cross-border bond trading is competitive
 - anonymity,
 - clearing and CCP
 - repo-netting
 - cross-border settlement, preferencing and chaining
 - fails management and liquidity products
- Too many linkages and CSDs/SSSs
 - largely administering government debt (with central bank oversight)
 - tend to be efficient, cost effective and low risk.
- Corporate actions and custody administration is less complex than equities.

Securities - Define

Equities

- Cross-border equities trading is fragmented
 - no sizeable competing systems
 - clearing and CCP in a few national markets
 - clearing and settlement fragmented; agent and custodian banks
 - no plain vanilla core service offering (ICSDs for bonds)
 - no integrated fails management and liquidity products
 - products and services tailor made for customer requirements
 - no post-trade capability for anonymous trading or netting
 - no preferencing or chaining
- As with bonds too many linkages and CSDs/SSSs
 - unlike government debt, equity services vary significantly from market to market (settlement, custody, registration)
- More complex custody administration
- As a result, market practices rules and processing methods are significantly different

Securities - Conclusion

Correct to focus attention on ***bond*** processing

Correct to focus on efficiencies/related costs, ***but!***

- ***the lack of centralisation*** (core plain vanilla settlement/depository service offerings) more important ***(and even essential)***
- ***and shortcomings*** or lack of clearing and cross-border CCP services which would facilitate and lead to substantial growth in ***cross-border equities*** processing.

Must be given priority

Convergence/consolidation - Define

Bonds

- Merge and fully integrate ICSDs – creates an entity valued at Euros 12 billion + + + +
- Euroclear Bank
 - major effort to integrate Euroclear Bank France
 - integration with CIK and NECIGEF not yet started
- Clearstream International – 50% owned by DBAG (interested in securing other 50%?)
 - Still to finalise integration of Clearstream Banking Frankfurt
 - Further complexity given its role as national CSD for Luxembourg

Convergence/consolidation - Conclusion

Bonds

- Has any organisation in the world succeeded in?
 - a *simultaneous merger*
 - *involving regulated financial institutions (including monopolies) in 6 different countries*
 - different organisational cultures
 - different IT systems
 - different laws, regulations and market practices
- *Critical success factors* for a *managed change*?
- *Concerns* from an *operational risk* perspective?
- *How long* would you estimate for integration?
- What *incentive does a small national CSD* have to join a EUR 12 billion + + + + organisation?

Not easy - I rest my case!

Convergence/consolidation - Conclusion

New role for ICSDs?

- NewCo 1 created with subsidiaries, Euroclear Bank and Clearstream International
 - Euroclear Bank provides the cross-border solutions for the market (already has over 80% of market turnover)
 - Clearstream Banking responsible for integration of national market CSDs – Luxembourg, Germany, France, Netherlands, Belgium
 - Creation is adopted as strategic IT solution
 - Links are eliminated because of single entity
- Regulated like SWIFT - central bank in host country chairs committee of other EU NCBs
- This approach is based on Euronext

Convergence/consolidation - Define

Equities

- Requires core business offering in equities (comparable to ICSDs for bonds)
- Utilise existing links (agent bank) to national markets (as is case with ICSDs)
- Cooperation between agent bank/custodian back offices
- White label services provided to smaller market players
- For-profits motivated given high investment needs and complexity of consolidation process.
- Regulated as 'dominant position' supplier
- Requires goodwill of issuers and investment banks to create CSD operating out of best location (laws, regulations, market practices)

Convergence/consolidation - Conclusion

Equities

- Complex cooperation process best served by progressive bilateral merger approach
- Valuation of increasingly powerful organisation could become barrier to new potential partners
- Issuers/investment banks essential partners to create polarised solution at depository level
- Treated as an 'embedded payments system'
- Regulated like SWIFT - central bank in host country chairs committee of other EU NCBs

Convergence/consolidation - Define

Clearing and CCP

The market situation

- Few EU countries with CCPs
- LCH and Clearnet failed to reach agreement on cooperation and subsequent merger
- Clearnet has invested heavily in IT systems solution
- LCH has no desire to become a systems factory
- Nordic markets developing own solution
- Other countries sitting on the fence
- Central banks/regulators concerns
 - concentration of risk
 - increased potential for systemic risk
- Netting reduces transaction volumes to CSDs - and therefore revenues

Convergence/consolidation - Conclusion

Clearing and CCP

- Polarisation to one CCP organisation excessively political and complex – *defer/abandon*
- Create NewCo 2 administering industry agreed general terms and conditions
- NewCo 2 puts in place agreements with CCP services providers
- NewCo 2 pushes for use of common system (Clearing 21?)
- NewCo 2 does not assume any risk but seeks to ensure that risks are managed or mitigated
- Note this model is based on GSTPA
- NewCo 2 is market-owned/user-governed not-for-profit governance – subsidiaries are self financing

Discussion scenario

- Equities vs. bonds; separate analysis/proposal
- Equity issues first priority - CCP, settlement and depository
- Create equity processing solution - ICSD equivalent - bilateral merger
- Create NewCo for CCP services
- Create NewCo for international (bond) and domestic (bonds/equities) settlement/depository services
- Forget about the business case
- Forget about cost comparisons with US market
- Focus on investment control and risk mitigation – use what's available
- Accept that its an act of faith

*Consolidation
And
Concentration of risk*