ECMI Lunch Time Meeting
June 26th 2012 | CEPS | Brussels

Unleashing Competition in Financial Market Infrastructure

Discussion with Xavier Rolet, CEO LSE Group

ECMI
Informing policy on European capital markets

MEETING REPORT

Xavier Rolet, CEO, London Stock Exchange Group

This 'event report' is not a transcription of the speech and may therefore not fully reflect the views of the speaker; you are kindly requested to contact the speaker before attributing any quotes.
The views expressed by the speaker are attributable only to him and not to ECMI or CEPS.

Markets have undergone sweeping changes after the demutualisation process. Incredible opportunities are opening-up but still there are great challenges ahead for competition in market infrastructure.

"Fixed income is a bigger and more important class for us than shares"

As a result of the banking crisis, an increasing number of structured products and other non-equity instruments will not move onto banks' books anymore, and so there is a growing need to issue and trade these instruments in the open market. However, transparency requirements need some fundamental calibration to accommodate more important liquidity needs. For instance, additional calibration is needed to preserve the client's ability to hedge risk in commodity derivatives. The process of centralisation of clearing should continue, building upon the evidence that market infrastructure worked well in the 2008 crisis: It took less than 15 days to resolve CCP-cleared transactions, while it took months (and perhaps still years) to resolve transactions cleared bilaterally and many transactions have not been actually resolved yet. However, centralisation is no panacea either. For instance, in relation to trading, turnover of OTC derivatives is only 1 to 40 as markets are unable to price risk at all times. The definition of 'sufficiently liquid' financial instruments under MiFID is going to play a key role and CCPs should not be forced to clear products and deal with risks that cannot be safely managed. Clearing is certainly at the centre of this process, therefore CCPs must be sound and well-capitalised. Central securities depositories, then, will represent the last frontier of market infrastructure.

"The exchanges landscape is highly anti-competitive for non-equity"

A more competitive environment can be achieved through striking the right balance between transparency and liquidity needs, especially for non-equities. The current landscape is highly anti-competitive, with the Deutsche Boerse and LIFFE monopolistic positions in their markets being a strong evidence of that. Access to CCPs is blocked by vertical silos and there is no legal foundation to keep access closed. However, intellectual property rights should be protected by giving exclusive license for a fixed period to new products but, after this period, benchmark instruments (such as indices) should be allowed to be traded on other venues. A commercially viable and non-discriminatory fee should be paid for that.

Urgent and bold actions are needed, both by regulators and supervisors (complementary to each other), to promote real competition and abate major barriers to entry. Markets are not growing anymore and, as of today, innovation is lacking after the key technological upgrades following the implementation of MiFID. The US, instead, is doing much better in this area. With greater competition, in effect, it should be possible to achieve cost savings of more than €600mn, excluding credit-risk costs and silo-related costs that are currently charged onto investors.

"LSE Group is the only exchange offering interoperability in shares and fixed income. We know what we are talking about."

LSE Group advocates a new horizontal business model (to be improved also in the equity space). The provision of access by LCH.Clearnet (in the process of acquisition) of 'Nasdaq OMX NLX' is an example of this model. Open access is the guiding principle. Claims that open access (and even more interoperability) would be a threat to financial stability and market integrity are unfounded. MF global is another example that closed silos are not necessarily safer. Deficiency in swapping margin at the end of the day is a fiduciary responsibility towards clients, which should be honoured and be performed at its best. Fungibility of economically-equivalent contracts (highly correlated assets) in CCPs' collateral pool should be the key point of discussion. By way of contrast, both LIFFE and Eurex forbid fungibility of liquidity and collateral pools. In Mr Rolet's opinion, a regulatory framework that would promote the model proposed by LSE would be able to produce much higher netting and compression rates, which could potentially reduce transaction size of 80-85% of nominal value and overall collateral costs as well. This would bring, on the one side, beneficial effects due to greater efficiency, and, on the other side, it would drastically reduce size and provide greater control over risk, resulting in a more stable environment. Sealing collateral pools with provisions that do not allow markets to evolve and access incumbent infrastructures would be harmful for efficiency, and ultimately for financial stability. Certainly non-delta-1 products are difficult to be traded, but, also in that case, interoperability may find space to develop. Moreover, another key element is the governance of the infrastructure. For instance, the new LCH will hold 5 seats in the board for users of the LSE Group and the LSE Group will not keep the majority of directors (as for Turquoise).
To sum up, the only way to complete the demutualisation process is to foster the ability of market infrastructure to be more open to competition.

"Debate on execution in the dark is surreal"

In relation to equity instruments, traditionally the core business of stock exchanges, there has been a drop in fees but, at the same time, also a fall in the average trade size of 50-60% —down to levels that were unthinkable some years earlier. However, more realism is needed vis-à-vis dark trading in Europe. Figures claiming size of dark trading close to 50% of the market are incorrect. Only 10-15% is traded outside the lit market, and dark trading is a legitimate business that, from an exchange viewpoint, should be allowed only if there is a price improvement to protect open-limit prices. Once more, the balance is between transparency and liquidity.

“Financial services regulation is the art of compromise but orderly, resilient and efficient markets are a safe pass for growth”

From a more macroeconomic perspective, creating jobs and wealth is the ultimate objective, and securities markets can serve the real economy in achieving this goal. Equity financing for innovation is paramount but this is an area where Europe suffers an important deficit, in comparison to the number of funding tools available in the US. Monetary policies and tax deductibility of debt has not helped the economy to free itself from traditional banking. Bank debt is the wrong tool to finance start-ups and innovation. Equity financing does not carry interest rates, nor the duties linked to the debt. A financial transaction tax would most likely depress equitiy and be very detrimental in this respect. The FTT is a tax on entrepreneur, not on banks.

These are still critical times for Europe and providing better funding tools to SMEs may prove a ‘game change’. SMEs in Europe are over 23mn, a number that is close to the official numbers on unemployment. The first issue that SMEs experience is the access to capital, which is often too difficult and too costly. More work should be done to improve accessibility and to reduce bureaucratic and fiscal burdens.

MORE INFORMATION

www.eurocapitalmarkets.org/rolet

----

3 July 2012

Diego Valiante