

Issues related to central counterparty clearing: Opening remarks

Gertrude Tumpel-Gugerell

First of all, I would like to say that I am extremely delighted to welcome you to this conference and to Frankfurt—a city that offers a huge variety of facets based on almost 2,000 years of history. Frankfurt was not only the home of important writers and philosophers, such as Goethe, Schopenhauer, and Adorno, it has also over the centuries prospered as a marketplace and magnet for business. Key to this success was its central location at the crossroads of large trading routes between the North and South and the East and West. Finance followed trade, and early on, Frankfurt became not only the home of large trade fairs but also an important financial center. It was one of the birth places of our modern stock exchanges, bringing about early financial innovations, such as trade with derivatives or bonds. When I look at the history of Chicago, I see a lot of similarities to Frankfurt: Chicago developed from a trading hub of agricultural products into a financial metropolis with a very potent stock exchange.

I am therefore very proud that this conference is a joint conference organized by both the European Central Bank (ECB) and the Federal Reserve Bank of Chicago (Chicago Fed), and I would like to give a particularly warm welcome to all our colleagues from Chicago. Cooperation between the ECB and the Chicago Fed is very well established: We have close bilateral exchanges and meet regularly in international meetings. Yet, most of our cooperation is often rather invisible to the public at large. Thus, I am particularly glad that this conference highlights visibly the close collaboration between the ECB and the Chicago Fed. It also demonstrates that we witness similar developments in both the United States and Europe and that we can benefit from each other's experiences by analyzing these developments together.

As you can see from the program, this two-day conference aims at exploring the foundations of central counterparties (CCPs), the importance of collateral

and margining, issues related to risk management, and future developments of financial market clearing and settlement. The conference provides a unique forum for discussion and will allow participants to interact with industry executives, policymakers, central bankers, and academics. I am confident that by the end of the conference, we will all have a better understanding of the driving forces, practical arrangements, and the legal environment within which the CCPs operate in the European Union (EU) and the United States, as well as the future developments of financial market clearing and settlement.

Before I give the floor to the panelists, I would like to set the stage by presenting ten statements on key issues related to central counterparty clearing. I will emphasize our wish to achieve an efficient, sound, and stable “domestic” securities market infrastructure in Europe.

Central banks have a keen interest in the smooth functioning of central counterparty clearing

Central counterparties represent an integral element of securities settlement systems. Although a CCP has the potential to reduce the risk exposures of market participants, it also concentrates risks and the responsibility for risk management. In the light of the growing interest in developing CCPs and expanding the scope of their services, central banks have a strong interest in the development of a coherent and integrated securities clearing and settlement infrastructure.

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Although the Eurosystem is not directly involved in the regulation of CCPs, issues related to the clearing and settlement infrastructure touch on the key responsibilities of central banks:

- The smooth functioning of payment systems, and
- The preservation of financial stability.

Guided by these objectives, the Eurosystem has explicitly expressed its interest in monitoring, understanding, and promoting the development of sound, efficient, and safely functioning financial market infrastructures. In this light, the ECB and the Chicago Fed have organized this joint conference on the role of CCPs.

The importance of post-trade processes and services for the overall economy will grow significantly

Capital markets play a vital role for the global financial system and for long-term economic prosperity. In particular, securities markets facilitate the effective allocation of capital by funneling society's resources to promising productivity-enhancing investments across space and time. The marketplaces operated by exchanges and clearing and settlement institutions have grown at an unprecedented pace. This gives them a central role and responsibility in the global financial environment. In particular, post-trading processes and services, typically referred to as clearing and settlement, are a key part of modern capital markets. From a market perspective, their importance derives from the fact that clearing and settlement costs can be viewed as a subset of transaction costs. These are the costs faced by an investor when carrying out a trade. Expensive and inefficient clearing and settlement limit the development of efficient markets.

The most recent performance figures for the five major European clearinghouses confirm this trend. After the introduction of the euro, the volume of trades cleared increased by a factor of 2.5, reaching a record of around 670 million trades in 2004, which represented a value of close to 350 trillion euro. These figures clearly show that a significant amount and value of securities are held and transferred in these systems. It is therefore crucial that the safe, sound, and reliable functioning of clearing and settlement systems is ensured.

Financial innovations and technological advances will continue to be the key drivers for the financial infrastructure industry

The practices and procedures involved in clearing and central counterparty services are currently undergoing a process of evolution in Europe and the United

States. Developments in technology, advances in the design of financial products, and progress in techniques for management of financial risk have prompted some market participants to advocate the development of clearing arrangements on an international basis. This would allow capital to be used as efficiently as possible. At the same time, the financial soundness of existing clearing arrangements needs to be maintained.

There are two main trends that present numerous challenges for market participants, infrastructure providers, central banks, and financial market regulators: first, developments regarding operational arrangements and the functions of clearinghouses, which I will elaborate on in the following section, and second, consolidation initiatives in the clearing infrastructure, which I will address later.

Central counterparty clearinghouses will increasingly perform essential functions in the transaction value chain

Let me now turn to the operational and technical arrangements of clearinghouses. A clearinghouse determines the obligations that result from debit and credit positions arising from the trading of financial assets. It calculates the amounts that need to be settled, typically through securities settlement systems. The clearinghouse may act as a buyer to the seller and as a seller to the buyer. It thus creates two new contracts that replace the original single contract.

Many of the benefits of central counterparty clearing can be attributed to multilateral netting. Multilateral netting allows for a substantial reduction in the number of settlements and, therefore, in operation costs, including settlement fees. In addition to multilateral netting, central counterparty clearing creates benefits mainly by providing risk-management services. Central counterparty clearinghouses thereby enable market participants to trade without having to worry about the creditworthiness of individual counterparties.

Central counterparty clearing not only creates benefits for individual participants, but it is also essential for the economy as a whole. This is because central counterparty clearinghouses increase market liquidity, reduce transaction costs, and improve the functioning of the overall capital market.

There is a need for adequate risk-management procedures and standards for clearinghouses

Securities infrastructures, in particular central counterparty clearing systems, are vulnerable to failure if they are not sufficiently protected against financial and nonfinancial risks. In fact, if such risks do materialize, the consequences for the stability of the

financial system could be enormous. It is therefore particularly important that appropriate measures are taken to mitigate these risks. Consequently, the effectiveness of a CCP's risk controls and the adequacy of its financial resources are critical aspects of the infrastructure of the market it serves. Clearinghouses have developed different methods of limiting the potential losses arising from the default of a participant. Some of these safeguard measures and their effectiveness in limiting risk exposures will be addressed in the course of this conference.

Given the potential systemic implications of securities clearing and settlement systems, the establishment of standards for risk management is essential. The process of setting standards has already started, with initiatives being driven by market participants or pursued in the framework of international cooperation between regulatory bodies.

Competition, transparency, and open access are important to address the interests of customers and public authorities

The Eurosystem is of the view that competition is important to achieve the overall objective of creating a safe, efficient, and integrated EU clearing and settlement infrastructure. The basic conditions for this goal are transparency and open access. Efforts undertaken by a CCP help to improve transparency and foster confidence of market participants in its safety and efficiency. It is therefore essential that a CCP provides market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services. To avoid discrimination against classes of participants and competitive distortions, participation requirements should be fair and open within the scope of services offered by the CCP. However, these rules and requirements for fair and open access should be balanced against and aimed at controlling and limiting risks.

Looking ahead, the adoption of a harmonized regulatory regime for securities clearing and settlement systems should be considered in order to complete the internal market. In this respect, an approach that sets out requirements for transparency and participation as instituted in a jurisdiction seems to be preferable.

In this light, the Eurosystem welcomes the initiatives specified in the European Commission's communication on clearing and settlement. The Eurosystem, in principle, supports the adoption of a framework directive on clearing and settlement. A directive could complement the market-led removal of the existing barriers to efficient EU clearing and settlement arrangements. This is a necessary condition for competition

to come into full effect. It may contribute to ensuring open and fair access and price transparency. However, the Eurosystem cautions that the concerns and responsibilities of central banks as regards a safe and integrated securities infrastructure need to be adequately reflected in a potential directive on clearing and settlement. The Eurosystem also understands that a legal and regulatory framework will not impede the continuing cooperation in the area of supervision and oversight of securities clearing and settlement systems. This is essential in order to further improve and follow up on the establishment of common European standards on clearing and settlement.

Integration of European securities clearing infrastructures will proceed at different speeds and with more diversified and enlarged businesses

In the euro area, most countries have established central counterparty clearinghouses. Projects to set up new central counterparty clearinghouses are also under consideration in several countries. Typically, CCPs are attached to particular local organized markets, that is, stock or derivatives exchanges. The European clearing infrastructure inherited from the pre-euro era was a patchwork of national systems operating within their geographical boundaries.

However, the pattern of a single central counterparty clearinghouse serving one market in one country has been changing. Since the start of the European Monetary Union (EMU), a process of integration and consolidation has been under way in the field of CCP clearing. Integration within the securities clearing infrastructure has taken the form of vertical and horizontal consolidation. In the past five years, the number of CCPs for financial instruments has dropped from 14 to seven in the euro area.

In the European context, there have been significant changes in central counterparty clearing, and these have led to increased consolidation among securities clearinghouses. The majority of trades are cleared in a very small number of clearinghouses in Europe. However, a high number of CCPs with a relatively small market share still operate in parallel at the local level. As a result, the Eurosystem is of the view that the process toward further consolidation is making progress but is still in its infancy. On account of the economies of scale and network externalities inherent in the securities clearing business, further cost savings and increased technical efficiency can be expected from more integration and consolidation.

In addition to the tendency toward consolidation of CCPs, another trend can be observed in the field of CCP clearing. At the start of the EMU, almost all

CCPs in the euro area cleared only derivatives transactions. However, in recent years many CCPs have expanded their activities and now also cover repos and securities trades. The CCPs appear to be seeking new business opportunities in an increasingly competitive market. In this context, there is another field of business opportunities for CCPs that has not yet been fully exploited. I am referring to the over-the-counter derivatives markets. These markets have grown substantially in recent years, but their post-trading infrastructure remains somewhat underdeveloped.

The consolidation of CCPs and the expansion of business tend to go hand in hand with the growing volumes in securities trading, advances in technology, and the internationalization of the activities of clearing and settlement infrastructures.

Comparing experiences in the United States and Europe for achieving a consolidated and efficient clearing infrastructure

Looking across the Atlantic, it is interesting to compare the existing organization of domestic clearing arrangements in the United States and the European Union. Recently, major market participants have repeatedly expressed support for the idea of a single European central counterparty clearinghouse, which would be designed as multicurrency and multiproduct. Such a single central counterparty in Europe would be expected to create clearing arrangements that mirror those in the United States. It is often said that clearing arrangements in the United States are more consolidated and cost-effective than those in Europe. However, an examination of the case of derivatives clearing suggests that the main features of central counterparties in the two currency areas are not fundamentally different. In particular, when looking at the level of consolidation, the situation is far more complex than is commonly thought. For example, in the United States, the decentralized clearing of futures transactions derives primarily from the business decisions of exchanges and clearinghouses to maintain separate operations. In addition, sectoral regulation in the United States impedes the development of cross-product clearing, leading to seemingly less integrated clearing arrangements than those in Europe.

The Eurosystem's guiding principles are neutrality, market forces, public policy decisions, and cooperation at the global level

As yet it is unclear which model of integration will eventually prevail in the euro area. The Eurosystem is of the view that the process of consolidation of the central counterparty clearing infrastructure should

be driven by the private sector. Public intervention might be needed if there are clear signs of market failure. For example, a persistent lack of interoperability and the need for standards among clearinghouses are examples that call for coordinated public action.

Irrespective of the final architecture, it is essential that access to clearing, as well as trading and settlement, facilities should not be unfairly impeded. The policy of open and fair access should ensure the safety, legal soundness, and efficiency of securities clearing and settlement systems; guarantee a level playing field; and avoid excessive fragmentation of market liquidity.

The Eurosystem supports cooperation in central counterparty clearing at the global level. Key concepts in this respect are legal feasibility and interoperability. Interoperability means agreeing on common processes, methods, protocols, and networks to enable cooperation between central counterparties at the technical level. This would allow central counterparty clearinghouses worldwide to develop links between one another. As a final outcome, this may or may not lead to the creation of international or global clearinghouses. Furthermore, when global multicurrency systems handling euro begin operations, the Eurosystem should be involved in their oversight, given its interest in the smooth functioning of such systems.

The financial infrastructure industry needs to take advantage of the opportunity window that integration offers

Tomorrow's global securities market infrastructures will be characterized by ongoing integration and consolidation initiatives. However, the message that I would like to convey is that action to promote financial integration in the field of clearing and settlement is urgently needed. In a fast-evolving global financial system, there is a window of opportunity to raise the euro area's financial infrastructure to the highest levels of efficiency, competitiveness, sophistication, and completeness. The window of opportunity was opened by the euro, but it will not remain open forever. The shape of the euro financial system is likely to be determined in the next few years and remain crystallized in that shape for a very long time.

In this respect, post-trading service providers should devise strategic responses in a number of directions in order to best increase business opportunities and to meet investors' demands for lower trading costs, improved liquidity, and immediate access to international clearing and settlement. Economies of scale, efficiency gains, greater risk diversification, and global networks encouraging competition and

consolidation in the securities infrastructure industry will be key to this development. Transatlantic linkages or cooperation would also stimulate financial market infrastructure dynamics. Moreover, the Eurosystem takes the view that the finalization and implementation of the European System of Central Banks–Committee of European Securities Regulators (ESCB–CESR) standards for clearing and settlement in the EU based on the recommendations by the Committee on Payment and Settlement Systems–International Organization of Securities Commissions (CPSS–IOSCO) are essential to ensure the sound and smooth functioning of the financial clearing infrastructure in the EU.

Conclusion

I would like to conclude my speech with a reference to German literature—quoting Johann Wolfgang Goethe, who was born here in Frankfurt more than 250 years ago. He said that the best that history teaches us is the enthusiasm that it evokes (“das Beste, was wir von der Geschichte haben, ist der Enthusiasmus, den sie erregt”). In the spirit of Johann Wolfgang Goethe, my wish for the future is that all relevant

market participants, actors, and authorities in the field of securities market infrastructure take their lesson from the past and promote with their best efforts, dynamism, and enthusiasm the development of a better, integrated, efficient, and safe financial infrastructure landscape. Moreover, we should learn from each other: from our analytical work and from our cooperation. A priority for the future is to pursue a consistent implementation and application of the EU-wide and harmonized rules for clearing and settlement. Successful cooperation among the relevant European and national supervisors and authorities is an important and challenging task. The private sector also has to play its role and take up its responsibility to foster further integration. In this context, it is time for the financial industry to leverage its efforts to higher degrees of efficiency and take full advantage of the opportunities that integration offers. To this end, technological advances and financial innovation will be the factors of success to keep pace with increasing competition at the global level. And financial innovations should go hand in hand with adequate risk measures for an efficient, but also safe and stable, financial sector.