COMMENT

JILL CONSIDINE

Let the customers decide on European clearing

You can almost hear the hammers pounding and the saws buzzing as the architecture of Europe's financial marketplace changes. This isespecially so in the institutions that operate the post-trade clearing and settlement systems. One of the larger projects is the merger of LondonStock Exchange's principal clearing agency, London Clearing House, with Clearnet, a clearing organization owned by Euronext, the LSE's sometime competitor.

Progress is being made but it is far from obvious who holds the blueprint for change. Industry organizations, the European Commission and the Group of Thirty have all weighed in with studies and recommendations to spur market consolidation. Some fear that without general consensus on clearing and settlement, cross-border securities trading in Europe will remain hampered by inefficiencies, high costs, high risks and opaque governance.

Oddly, the approach that has received least attention is based on a tenet dear to most in the world finance – a belief in the efficacy of market forces. In other words, forget the blueprints, forget the models. Listen to the concerns of customers and let the markets take their course. Form, after all, follows function.

The pivotal question, of course, is who determines those functions. And the answer, as ever, is that the customers do. Technological changes and regulation influence the process. But customer needs define the functions that financial institutions must fulfil. And eventually those institutions evolve a structure that will allow them to fulfil those functions efficiently.

That is more or less what happened in the US. Nearly 30 years ago, when the Depository Trust & Clearing Corporation's subsidiaries were first created to service the New York Stock Exchange and Nasdaq, clearing and settlement in the US looked more like Europe today. In addition to DTCC, a similar business was maintained by each of the five large regional exchanges throughout the US.

Oddly, the approach that has received least attention in the debate on clearing and settlement is based on a tenet dear to most in the world finance – a belief in the efficacy of market forces.

Over the years, as trading volumes grew and regional firms became national companies, traders began complaining about the need to maintain separate collateral accounts at each clearing and settlement organization. Broker/dealer customers became tired of the costs resulting from the need to reconcile end-of-day balances with multiple clearing houses, each with different and often incompatible rules. There was a growing realisation that there was little opportunity to take advantage of the efficiencies and risk reduction that would result from multilateral netting.

The rest is history. It took three decades but in the end the broker/dealers and the banks got what they wanted – a highly efficient clearing and settlement system to satisfy their needs, one that they themselves own and continue to oversee. Today, DTCC subsidiaries clear and settle nearly all US market transactions in equities and bonds, as well as clear trades in government and mortgage-backed securities. To clear and settle an equity trade in the US now costs about 9 cents. Through multilateral netting, DTCC reduces by 97 per cent the total value of equity trade obligations that require financial settlement.

In short, this is a story of form following function, of market forces prevailing. Customers wanted to commoditise clearing and settlement functions that offered no competitive advantage and that, once centralised, would return the benefits of reduced costs to themselves, the end-users – and that is what happened.

Whether Europe's clearing and settlement structure comes to resemble that of the US is not the question. The question is whether, with regulatory encouragement, Europe's infrastructure organizations and some sections of the securities industry itself well step back enough to give market forces free play. In the US, a unified regulatory approach helped create an atmosphere conducive to rationalizing clearing and settlement. To its credit, the European Union has done much to foster such a unified approach. Indeed, Europe has made substantial progress towards a more coherent structure in far less time that the US.

While Europe's domestic markets are as efficient as any in the world, the challenge of creating a seamless, cross-border trading environment remains considerable. But I am confident that, if customers are allowed to take a lead, Europe will find it an effective way to develop a unified and robust capital market.

The writer is chairman and chief executive of the DTCC.