



EUROPEAN CENTRAL BANK

# THE EUROSISTEM'S POLICY LINE WITH REGARD TO CONSOLIDATION IN CENTRAL COUNTERPARTY CLEARING

## 1. BACKGROUND

Since the introduction of the euro in 1999, there has been growing demand for central counterparty clearing. Several central counterparty clearing houses already exist in the euro area and a number of mergers and alliances are currently under consideration or being implemented. Economies of scale and network externalities seem to favour a high degree of concentration. A group of major global investment banks has therefore expressed support for the idea that Europe should only have one central counterparty clearing house, which would be a multi-currency and multi-product (equities, bonds, derivatives and commodities) service. However, there is no single view, particularly within the euro area, about the infrastructure that should prevail.

The Eurosystem is carefully monitoring and analysing these developments. Indeed, central counterparty clearing could have implications for the smooth execution of monetary policy operations, the smooth operation of payment and settlement systems and the stability of the financial markets in general. The consolidation process adds to the complexity of the issue: on the one hand, consolidation in central counterparty clearing could help to increase efficiency in the clearing and settlement of securities; on the other hand, the potential systemic consequences of a central counterparty's failure increase with its size.

## 2. POLICY CONCERNS

### (a) Need for risk management standards

In view of its statutory responsibilities with respect to the smooth operation of monetary policy and payment systems and its concerns in the field of financial stability, the Eurosystem has an interest in the functioning of central counterparties that clear substantial amounts of euro-denominated assets.

It is essential that standards for risk management be established for central counterparties. This work will be conducted in co-operation with the other relevant authorities (and with

the newly created Committee of European Securities Regulators in particular). The process of setting standards has already started, with initiatives driven by market participants or pursued in the framework of international co-operation between regulatory bodies. For instance, the European Association of Central Counterparty Clearing Houses (EACH) has developed standards for central counterparties, which should now be assessed by the Eurosystem.

### **(b) The need for a “domestic” infrastructure located in the euro area**

Currency areas have traditionally developed their own domestic infrastructures for payment systems, securities settlement systems, stock exchanges, etc. In this regard, it is important to distinguish clearly between “domestic” systems, on the one hand, and “international” (or “global”) systems, on the other. A “domestic” system is a system, which handles mainly or exclusively assets denominated in one currency. An “international” system is a system, which handles several currencies at the same time.

Defining a domestic system on the basis of currency enables public authorities (and the Eurosystem in particular) to address better their regulatory/oversight concerns. The logical geographical scope of a market infrastructure is in practice the currency area, as witnessed by the ongoing consolidation of stock exchanges, payment systems and securities settlement systems in the euro area. Indeed, payment, clearing and settlement systems may trigger liquidity problems, which can only be addressed by competent local authorities, in particular central banks. This is the case today in the United States and Japan. Now that the need for securities clearing is growing rapidly in the euro area, it would appear that a coherent domestic infrastructure for the euro will have to develop.

Such an infrastructure should logically be located in the euro area, as is the case with core infrastructures in other monetary areas. This would be preferable from a regulatory perspective and would help the Eurosystem, as the “central bank” of the euro, to ensure the smooth functioning of payment systems, efficient monetary policy implementation and financial stability. Existing agreements among central banks give a prominent role to “domestic” authorities, as do the international agreements among central banks and possibly with securities regulators. The existence of such agreements would make it easier to achieve effective oversight of central counterparties established in the euro area. Furthermore, the location of central counterparties in the euro area would facilitate the provision, when deemed necessary and appropriate, of central bank money in euro.

### **(c) Neutrality: market forces, co-operation and public policy decisions**

There are various forms of integration in central counterparty clearing, such as interoperability, alliances, joint ventures and mergers. All of these approaches have in common that they could help to improve market efficiency. Market participants need to look

for solutions, which are optimal in the long run, i.e. capable of maximising economies of scale and minimising the average transaction costs to the final users. However, it is acknowledged that in practice interim solutions could be necessary. The Eurosystem, at this stage, intends to remain neutral on the path that will eventually be taken towards improved efficiency and the optimal solution.

The three main driving forces pushing market participants to adopt efficient solutions in the field of central counterparty clearing are competitive pressures, co-operation between market participants and, when needed, policy decisions. The Eurosystem shares the view of the "Committee of Wise Men" that the process of consolidation should in general be driven by the private sector, which, however, does not mean that there are no public policy issues involved. Public authorities should help by removing unfair and unjustified barriers to integration and competition, such as legal impediments and a lack of standardisation.

#### **(d) Defining efficient market structures**

The issue of efficient market structures is closely related to the question of whether or not central counterparty clearing is a natural monopoly. It is clear that, in the short term, a single infrastructure would maximise network externalities and economies of scale. However, these short-term advantages have to be balanced against the inefficiencies that may be caused in the long run by the absence of competition (e.g. a lack of dynamism and innovation). At a time when former natural monopolies, in the fields of telecommunications, energy and transportation for instance, are progressively being dismantled, the emergence of new monopolies in the financial sector might be questionable.

Vertically integrated structures where trading, clearing and settlement are made available to the customer as a package enable local markets to be more efficient by providing better and lower priced services. However, they may also present some drawbacks in terms of lack of competition. The disadvantages can be overcome provided that customers can choose between systems along the "value chain" (i.e. trading, clearing and settlement). It is therefore crucial that access to essential facilities, whether vertically integrated or not, should not be unfairly impeded. For example, in the case of common ownership of trading platforms, the central counterparty clearing house and settlement systems, access to post-trading facilities should not be made conditional upon the execution of trades on the affiliated trading platform. The Eurosystem is aware that full interconnectivity of trading, clearing and settlement systems may not be easy to achieve because it may present operational difficulties and have the potential for systemic risks. It should be noted that no central counterparty clearing house or settlement system can be compelled to establish links if this is not commercially viable or compromises the sound prudential operation of the system. However, the reasons for failing to make links available should not be so open-ended as to allow abuse. Finally, open access to essential facilities must ensure a level playing-field for

service providers. In particular, legal difficulties, preferential taxation rules and lack of standardisation must not lead to unfair competition.

**(e) Co-operation at a global level**

The existence of domestic infrastructures does not prevent the emergence of international infrastructures. The international infrastructures are superimposed on domestic ones, however, and are not designed to replace them.

The Eurosystem supports co-operation in central counterparty clearing at a global level. Key concepts in this respect are legal feasibility and interoperability. Interoperability means agreeing upon common processes, methods, protocols and networks to enable co-operation between central counterparties at a technical level. This would allow central counterparty clearing houses world-wide to develop links between them so that agreements on cross-collateralisation and cross-margining could be reached. This may or may not lead to the creation of international or global clearing houses.

Furthermore, when global multi-currency systems handling euro are up and running, the Eurosystem should be involved in their oversight given its interest – as the euro's central bank of issue – in the smooth functioning of such systems.

In the light of the analysis above, the Governing Council of the ECB has come to the following conclusions:

- a) Owing to the potential systemic importance of securities clearing and settlement systems, the Eurosystem has an interest in central counterparty clearing and considers that it is essential to establish, in co-operation with the other relevant authorities, effective risk management standards.
- b) The natural geographical scope for any "domestic" market infrastructure (including central counterparty clearing) for securities and derivatives denominated in euro is the euro area. Given the potential systemic importance of securities clearing and settlement systems, this infrastructure should be located within the euro area.
- c) The process of consolidation of central counterparty clearing infrastructure should be driven by the private sector, unless there are clear signs of market failures.
- d) Whatever the final architecture, it is essential that access to facilities for trading, clearing and settlement should not be unfairly impeded. This 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.

e) The Eurosystem supports co-operation between providers of central counterparty clearing services at a global level and should be involved in monitoring global multi-currency systems handling euro as part of its interest in ensuring their smooth operation.