



Rolet's route from Armageddon

XAVIER ROLET, THE CHIEF EXECUTIVE OF THE LONDON STOCK EXCHANGE, SPOKE TO INFO MAGAZINE AT THE INAUGURAL CEO BREAKFAST ORGANISED BY THE FRENCH CHAMBER OF COMMERCE. HE BELIEVES THE ARMAGEDDON OF ECONOMIC MELTDOWN HAS PROBABLY BEEN AVOIDED. NOW IS THE TIME TO LOOK BEYOND THE CRISIS ITSELF TO THE DEVELOPMENT OF OUR REGULATORY SYSTEM AND TO COOPERATION BETWEEN REGULATORS, INFRASTRUCTURE PROVIDERS AND MARKET PARTICIPANTS.

INFO: How do you assess the role of regulators in the crisis?

XAVIER ROLET: The crisis, which was financial in origin, exposed the extent to which regulatory structures, whether in USA, Asia or Europe, have not been aligned. Indeed, the crisis has started a broader discussion about greater co-operation between national regulators, which is far from over.

How do you assess a new architecture for global regulation?

Governments have to look at ways to intervene and regulate financial companies in a coordinated fashion. We cannot do that if our regulatory structures are different. I think we are beginning to see greater regulatory co-operation across Europe, but also on a more global basis. Capital markets are, after all, global in scope.

Greater understanding of the distinction between the central bank and securities regulators is very important. I am inclined to think that the ultimate regulator of commercial banks, investment banks, insurance and finance companies should be the ultimate balance sheet company, which is the central bank.

Whereas securities regulators know about risk, central banks run their own, often-massive balance sheets, which give them a deeper insight into impending problems and the actions that might contain, limit or avert crisis. More importantly, though, when something does not look quite right, immediate intervention may be necessary. Intervention needs to occur not within two or three weeks; not after going through a parliamentary process, to see what adjustments need to be made.

In short, I believe that the regulatory system needs a central bank that intervenes immediately, using its balance sheet to take over the bank, with full lending authority and the ability to guarantee depositors.



Xavier Rolet

How do you assess the debate in the EU about trading practices?

There is currently a big debate about financial infrastructure. Regulators are looking at everything; not just the balance sheet but also at trading practices. There has been a serious debate in Europe about alternative investment management. We firmly believe that the proposed European alternative investment directive is misguided. However, there has been much debate about what hedge funds are about; about short selling, activism. These things are coming to the fore. It is very important for a strong central security regulator to aggregate the

different elements in the debate, and to come out with a strong, integrated proposal.

Could you assess the likely look of European regulation?

We are likely to see a pan-European process that drives a more harmonised and integrated regulatory process. This should enable participants to lower costs for concerned parties including issuers, banks, and of course consumers.

What is the consequence for banks of growing counterparty risk?

Counterparty risk is one element of the financial industry that still has not received enough attention. Although they are not leveraged in the way banks can be, clearing houses for example carry counterparty risks far in excess of the combined balance sheets of all the banks. The smooth functioning of the capital markets is critical. It is essential, in our opinion, that the regulatory structure, funding mechanisms and risk management framework for these clearing houses and depositaries, be harmonised in order to help lower transactional costs and reduce systemic risks, helping alleviate banks' balance sheets and exposure to OTC derivatives in the process.

How do you assess the relationship between banks and exchanges?

The process of exchange demutualisation has resulted in – to a greater or lesser extent depending on the exchange in question – a fractured relationship between exchanges and their banking clients.

At the time of demutualisation, nobody much cared what became of exchanges. Their services were considered by many market participants to be low value-added, essentially processing services. As exchanges became listed businesses, banks invariably sold out to shareholders expecting financial returns. With little direct competition in an exchange's trading business, extracting what some saw as a monopoly rent was perhaps irresistible.

Consequently, a rift has emerged between stock exchanges and what used to be their members and users, who had now become their customers. The banks' view was that the bourses were not modernising swiftly enough, and were becoming a hindrance to the growth of liquidity and of volumes; and effectively they did not contribute their fair share to lowering the cost of capital.

Against this backdrop, banks and other market participants have sponsored some of the competing trading platforms we see today.

How do you intend to resolve the complicated and tense relationship with banks and other broking clients?

The London Stock Exchange is now actively engaged in repairing client relationships. It is very important that clients know what we stand for and know where they stand with us. We are pro-competition; but we also want to be part of the solution to their problems, and those of the wider industry.

As an exchange, we are in competition with a number of other trading venues and clearing houses. We do not mind this in the slightest; competition is good for us, it keeps us focused on the things that matter: our clients, our costs, our technology. To the extent that some of our competitors have emerged from our client base as a result of a rift between their expectations and what exchanges have been delivering, we need to close this gap.

In Europe, there is a tremendous opportunity for the market to grow quite considerably if the frictional cost of trading comes down. Europe, with a combined population of 450m accounts for 31% of world GDP; the US, with 300m people represents around 27% of world GDP. And yet, despite being comparable economic entities, the value of equity trading in Europe is less than a tenth of the levels found in the US.

In order to realise these opportunities, exchanges need to reduce their trading fees, but more significantly and more broadly, considerable changes need to be made to the cost structure of clearing and settlement across Europe. (Anomalous taxes, such as stamp duty on share transactions in the UK, need to be addressed.)

The industry needs to simplify and rationalise the way in which securities are cleared. Whether this is affected through regulatory and/or market-led solutions is a matter for debate.

Do you believe that competition and market forces hold the key to an efficient market, at least as far as securities trading is concerned?

There is no doubt in our minds that competition stimulates innovation and drives efficiency. However, at the heart of an exchange business is a contradiction that the most efficient market is a centralised one, where all buyers and sellers come together in a trusted, well managed environment.

Regulators are starting to resolve matters. They are trying to find a structure that is not opaque but is efficient, produces volume growth, and is cheap; that offsets risks and compensates for risks as much as possible.

At the London Stock Exchange, we believe that we can play a positive role in the debate over centralisation and cost cutting. Stock exchanges are central entities. We do not benefit if only the banks benefit, or if only the corporate issuers benefit. We are a neutral venue. We are consciously seeking to eliminate any imbalances within our own structure. Our goal is to promote efficiency, be able to offer services as cheaply as possible, and essentially be neutral. ■