

Interview with Xavier Rolet

Xavier Rolet, the chief executive of the London Stock Exchange, believes the Armagedon of economic meltdown has probably been avoided. Now is the time to look at the fundamental causes of the crisis, in particular regulation and the costs of trading and clearing.

How do you assess the causes and sources of the crisis?

The core of this crisis was definitely financial. The regulatory system, whether in USA, Asia or Europe, was not aligned. There was no clear debate in the UK as to the best way to regulate the financial industry in general, and how to regulate the UK in particular. The debate is not over.

However, if you look at the regulatory system in the USA, at the time of the demise of Lehman, it is clear that we had a significant segment of counter-party risk. Financial companies in the US were not regulated by the Central Bank. They were regulated by financial regulators, in particular by the SEC. So they were led a certain way, with certain prudential issues.

Central Banks in Europe were regulating things all by themselves. They offered a very effective way of keeping creditors at bay and look at ways of dealing with things - without going to the administrators, as happened in the UK. They were trying to preserve the balance sheet of companies and the core investment bankers. In Europe, the Central Bank were the key regulators.

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. You cannot do that if your regulatory structures are different. The distinction between the Central Bank and securities regulators is very important. Commercial banks, investment banks, insurance and finance companies should be regulated by the ultimate balance sheet company, which is the Central Bank.

There are two reasons for this. Whereas the regulators have to know about balance sheets, the Central Bank has to know about risk. It is not just a regulatory question, it is also a supervisory question.. Even more importantly, when something does not look quite right, you need an added mechanism where whatever intervention is needed, can happen immediately. It needs to occur not within two or three weeks; not after going through a parliamentary process, to see what adjustments need to be made.

You need a Central Bank that can come in with its balance sheet and take over the bank, with full lending authority. You need to be able to intervene immediately. You need to be able to guarantee depositors.

How do you assess the debate in the EU about investors' 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 very strongly oppose what we believe to be the thoroughly misguided European alternative investment directive that has been proposed. Yet 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 all those elements in the debate, and to come out with a strong 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 will be very good for participants, who will attempt to harmonise standards and lower costs for participants including issuers, banks, and of course consumers.

What is the consequences for banks of growing counter-party risk?

There is one element of the financial industry which still today has not received much focus. Counter-party risk far exceeds that of the combined values of all the banks of the world. The smooth functioning of the capital markets is critical. In the last six to nine months the banks have taken on themselves a substantial amount of balance sheet obligation. The banks have accumulated substantial exposure on the balance sheets with these transactions.

Could you assess the likely role of stock and other exchanges in the financial firmament?

There is no doubt that in the last eight years, with the process of demutualisation, exchanges have been seen as being more part of the problem than part of the solution. The bourses were owned by the state and they used to represent a service, a reasonably low value-added service, a processing service. Then they were demutualised and sold on. At the time, the banks and all the exchanges probably did not care much about what happened. This was very low down on their list of priorities. So these bourses eventually started getting listings. They were taken over by shareholders who insisted on financial returns. They inherited a monopoly. And that monopoly, if you are after a profit, can be quite a comfortable position. It attracts what some would call a monopoly rent.

That created a rift 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.

Could you indicate your position about the future structure of clearing houses and stock exchanges?

We want to get involved in the debate, around clearing houses or around the shape of the markets. We have come out with two arguments: First, as an exchange, we need to heal the rift with our markets. We are in clear competition with the clearing houses, which we don't mind; actually it is good for us: Competition forces us to keep costs down.

The flipside of that is that we are also pro-transparency. And that is actually a real issue! The reasons why exchanges were criticised by their clients was that the fees were too high. Look at Europe. It has 31% of world GDP, 450m people. And look at the USA: 300m people about, 27% of world GDP. So they are comparable economic entities. Europe trades \$25 to 30bn a day. The United States trades ? (can you help with the number, please?)

There is a clear problem in Europe about lack of volume and the slow turnover of velocity. In that context, the UK has the slowest turnover of any European country because of the taxation regime. The other issue is the high cost of trading in European securities. But more importantly, the high cost of clearing. The actual cost structure in Europe is very inefficient. Across the water it is even worse.

So what the industry needs to be doing today is to simplify, rationalise the way in which securities are cleared. And these could be regulatory solutions, or they could be private sector solutions. The private sector tends to be free by competition, hence more efficient than regulators. There is a big debate.

We want more competition to stimulate and make things more efficient. But of course with competition, by definition, you cannot have best execution as efficient as the central state. There are no simple solutions. Regulators are starting to resolve that; this is at the core of everything. 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.

The London Stock Exchange believes 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 used to have an imbalance where we were effectively opposing significant or certain types of transactions. This is not what we are after. We prefer promoting efficiency, offering that service as cheaply as possible, and essentially being neutral.