



**EACH response to the European
Commission public consultation on
'FINTECH: a more competitive and
innovative European financial sector'**

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Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of Central Counterparty Clearing Houses (CCPs) in Europe since 1992. EACH currently has 20 members from 15 different European countries and is registered in the European Union Transparency Register with number 36897011311-96.

EACH appreciates the opportunity to provide feedback to the European Commission ‘Public consultation on FINTECH: a more competitive and innovative European financial sector’ (hereafter called ‘The consultation’).

I. Bringing down operational costs and increasing efficiency for the industry

1. Disintermediating financial services: is Distributed Ledger Technology (DLT) the way forward?

Question 2.7: Which DLT applications are likely to offer practical and readily applicable opportunities to enhance access to finance for enterprises, notably SMEs?

Question 2.8: What are the main challenges for the implementation of DLT solutions (e.g. technological challenges, data standardisation and interoperability of DLT systems)?

Question 2.9: What are the main regulatory or supervisory obstacles (stemming from EU regulation or national laws) to the deployment of DLT solutions (and the use of smart contracts) in the financial sector?

1. Introduction

CCPs have always promoted the integrity, efficiency and transparency of global financial markets and the technological and other infrastructure advancements that have characterised the evolution of markets in recent years. These changes have been the catalyst for the development of more competitive, more efficient, and more transparent markets, as well as substantial improvements and innovation in risk management and regulatory capabilities. More recently, technological advances, regulatory pressures, and capital constraints are pushing the financial services industry to rethink many of its processes and structures, in order to facilitate cost reduction, and to make clearing and settlement more efficient. As these technologies advance, and are more widely adopted, they offer a more efficient means for market participants and market infrastructures to more efficiently manage their risk. It is perhaps too early to tell how far-reaching an impact these technologies will have on how participants trade, clear and report, but development is progressing at pace.

EACH members understand the potential impact that Fintech and DLT technologies may have on the CCP business and on financial markets more generally, and are involved in initiatives to encourage the development and to explore the application of such technologies.

2. Main Challenges for the implementation of DLT solutions

EACH members do not consider there to be weaknesses in the current organizational or operational structure of European CCPs but acknowledge that some market practices might be capable of being made more efficient. However, the scope for creating such efficiencies existed prior to the advent of recent Fintech technologies. What Fintech has done is to grab the attention of the industry, and present an opportunity to question some of the market practices that exist today. There are possibly also alternative solutions to achieving some of these efficiencies than the approach that DLT technologies provide.

EACH members believe that the following issues should be taken into account in the implementation and deployment of DLT solutions:

- **Technological challenges** - We believe that DLT may not only make the reconciliation process faster and more efficient but it may potentially make it unnecessary since the records are shared among participants. **It currently seems unclear what the impact would be on the current value chain of market infrastructures:** trading venues, CCPs, CSDs, CSD participants, final beneficiaries, etc. While every actor of the value chain currently plays a very specific role, market infrastructures are in constant evolution as a result of innovation and client demand, and therefore changes to the value chain as we know it cannot be discarded. CCPs have a proven track record of market adaption as shown by the constant evolution of their risk management techniques subject to client demand and in line with regulation. It would be **necessary to spend time to perform proof of concepts and to test the capabilities of DLT technologies.** This will help identify opportunities where DLT are the most appropriate approaches, or bring to light other technologies or approaches that can achieve greater efficiency. The CCP industry has spent considerable resource building infrastructure that works, is robust, and is scalable. There is potential for the application of new technologies to this infrastructure, but there is a question to be asked about how these technologies are going to improve of the existing systems and market structure.

It is important to remember that DLT is fundamentally a communication tool, relying on existing structures to transfer funds and securities in response to changes to the ledger. Whilst there may at some point exist the capability within DLT to provide instruction to prompt the exchange of margin or collateral between counterparties, at this stage the actual transfer must be performed via an underlying payment system (i.e. an interbank system), which operates outside DLT arrangements. We believe that it will eventually be the market itself that will decide if such a change to the value chain is worthwhile. **Any technology solutions, whether DLT based or otherwise, cannot be**

adopted in isolation. They will need to integrate with the network of existing systems, business processes and market structure.

It should be kept in mind that different market participants will also have different views as to which improvements technology developments should focus, whether that be in terms of speed or functionality, reduction of costs or manual processes, or the creation of new offerings.

- **Common industry standards/best practices** – Common industry standards are a major part of this process because an **important part of many of these technologies is the network effect.** They are not like typical industry developments, in which market participants build something proprietary. With these technologies, if there are not enough people in the network, then the true benefits will not be derived. For these reasons, EACH members consider that current CCP structures, processes and established methods of risk management are likely to still be important in a Fintech environment.

As with all technological advances, **EACH would support the move towards DLT to be driven by industry and business needs, rather than regulatory edict,** to ensure the technology meets the needs of market participants. It should be avoided that a fintech company which is essentially performing the same service as a regulated company, such as an exchange or CCP, has a comparative cost advantage performing that service, due to the fact that it is not regulated. If the industry moves in this direction, common principles to ensure best practices should be established when it comes to setting up and operating distributed ledgers. Further down the path when the technology and potential solutions becomes more mature the risk of multiple digital ledgers lacking any interoperability at a technical and business level as well as any potential operational fragmentation of the securities market should be considered.

- **Automation of the clearing process** – We believe that it would be **unlikely to achieve a full automation for all post-trade services,** in particular of the clearing process, given the regulatory and business complexity of automating some services and essential functions. Hybrid models are likely to be first developed for products and services where automation will create greater efficiencies. Application to large scale and heavily regulated activities will take more time. There are some crucial aspects to the clearing process that will remain outside of automated processes, including default and crisis management as well as key functions of risk management.
 - **Counterparty risk of certain securities transactions** - The incorporation of cleared transactions within the scope of a DLT environment would have no effect on the period to which one counterparty is exposed to the default of the other, and this credit risk must still be effectively managed until the contract in question is settled. Whilst DLT may support the ability of market infrastructures,

especially CCPs, to manage this risk, the introduction of these technologies would do nothing, in and of itself, to eliminate the risk. These **risks will remain in financial markets even where certain processes are carried out within a DLT environment, and the role of CCPs, and other market infrastructures, will therefore remain important** in mitigating and managing these risks.

DLT presents the **possibility to reduce the settlement cycle**, thus reducing counterparty risk. It should be noted however that shorter settlement cycles (and even T-instant) are not a unique advantage of DLT, and indeed could be performed on many current systems. In the case of CCPs, DLT may indeed eliminate the counterparty risk of certain transactions (e.g. securities and repos) and remove the need for CCP clearing for some contracts, but this is only in those instances where the trading is either on DLT or can be transferred to the clearing system in real-time (if outside DLT), e.g. T-instant. In other cases, CCP clearing would still be required, specifically for derivatives contracts where the risk to the counterparties extends beyond initial execution of the trade and requires management and maintenance of margin throughout the life of the contract.

As long as DLT works on full pre-funded basis, the DLT can indeed eliminate the counterparty risk of certain transactions. However, **the benefits of CCP clearing go beyond settlement**. DLT does not reduce the risk of a bilateral counterparty defaulting on obligations to its trading partners, a risk that CCP clearing reduces by guaranteeing performance of trades. CCPs additionally perform a series of risk, collateral, and default management processes that cannot be directly replaced by DLT.

EACH thinks it is important not to forget the amount and value of judgement based risk assessment that individuals within market infrastructures, particularly CCPs, play both on an ongoing basis and in stressed scenarios. We doubt that a smart contract could be responsible for triggering a declaration of default of a member without some human involvement. We therefore believe that there will continue to be a necessary and fundamental role to be played by market infrastructures in financial markets, even where certain aspects of those markets operate within a DLT environment.

- **Sharing of data for reporting** - We generally **support DLT as a potential benefit to facilitate the collection, consolidation and sharing of data** for reporting. We have to take into consideration that during any implementation and transition phase, DLT would operate in parallel to other systems, thus **requiring reference to multiple sources** in order to maintain complete oversight.

Even assuming full deployment of DLT where applicable, certain processes or asset classes may not be suited to a DLT environment and may operate on separate systems, thus requiring again multiple sources to be consulted in order to maintain a complete picture. Moreover, a single source of truth implies a single DLT system in use. After consideration by the industry, it may be determined that there is not a single DLT that will serve all of the needs of the market, requiring multiple DLTs to be deployed and more than one record to be monitored. Further, generally we question some assumptions that DLT can handle a theoretically unlimited amount of information at an increased speed. Currently, the technological capabilities can be increased by sufficient investment by the respective market participant. Therefore, the **collection, consolidation and sharing of data for reporting, risk management and supervisory purposes appears to be self-limiting via DLT.**

While a DLT can be offered as an open technical environment (e.g. public technology), it is highly likely that distributed ledgers, as applied to securities markets would be permissioned, ensuring only permissioned parties have access to data in applicable distributed ledgers. Nodes might have specific roles for respective functions (e.g. participating node or view-only node, such as regulatory bodies, supervisory authorities, etc.). **Oversight could be hence ensured, provided that specific access rights are put in place**, and particular participants are granted such privileged access.

On **regulatory reporting**, if supervisory authorities have a direct access as an observing node to all information relating to their regulated entities on the DLT available, **additional investment in technology on the recipients’ side may be necessary to ensure they can collect and analyse the data directly from the Ledger**. The manner in which regulators, trade repositories and other entities engage in regulatory reporting may need to be reconfigured in order to assist such bodies in parsing the available information efficiently and at sufficient speed. We further note that reports designed for audiences that do not have access to the DLT (e.g. public audiences) or that follow templates not supported by DLTs would continue to require reporting services.

- **Security** – While it is a widely held assumption that DLT is sufficiently secure to be used in financial markets, we would encourage that this assumption **be tested and verified prior to the productive use of DLT**. During the course of the implementation of DLT, it is key to have an agreed industry and international standard for data protection and confidentiality options for market participants. It is crucial that the high level of transparency provided by DLT does not conflict with the confidentiality obligations required for financial market participants.
- **Costs** - A variety of new technologies present possibilities for cost reduction and reduction in the need for manual processes, and these benefits are not solely limited

to a DLT environment. Cost efficiencies in DLT depend on whether the proposed advantages can be effectively achieved, which is already a challenge for the current generation of financial technology innovation, including robotics, cloud computing and so on. As mentioned earlier, we believe that the reduction of intermediaries appears to be mainly theoretical in the present market conditions. **Potential cost efficiencies could moreover only be achieved in the long-term perspective.**

DLT technology will likely have to be run in parallel to legacy systems to meet business and data security needs. Long-term, it may prove necessary to permanently maintain some data in parallel systems. At this point, it is unclear to say that DLT is guaranteed to reduce costs for participants.

In conclusion, EACH believes that the nature of DLT and their applications to the global financial markets gives rise to a broad range of commercial, operational, legal and regulatory considerations, and it is important to recognise that these considerations, and their materiality, will likely change as the technologies develop and are deployed. Recent technological advancements in this area have the potential to fundamentally change the underlying structure of financial markets, but technology alone is unlikely to improve the existing stability and security of the financial markets. We believe that **there remains an integral and prominent role for CCPs**. As market participants and regulators alike consider the next steps in their approach to Fintech, there is a heightened need to ensure that the legal and regulatory environment fosters innovation and progression, whilst maintaining the stability and security that provides a platform for the growth of such innovation.

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