

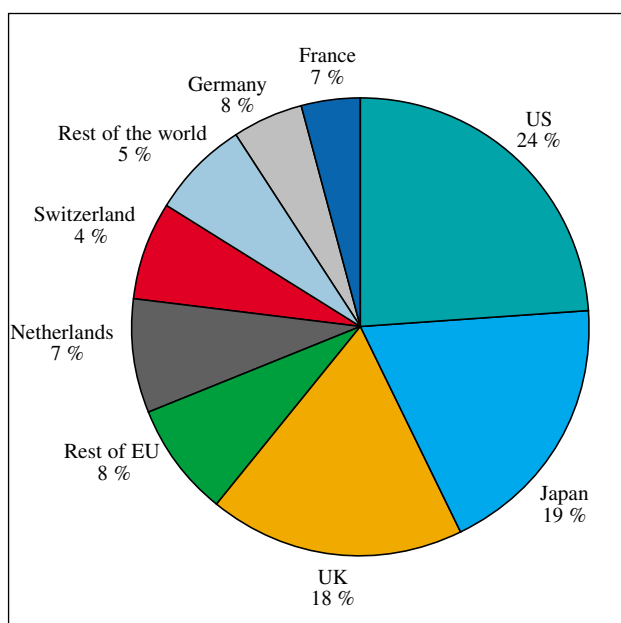
LCH AND LIFFE STRATEGIES UNDER CONDITIONS OF GLOBALISATION

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The London Clearing House is one of the largest clearing houses in the world. Following its establishment in 1888 it at first cleared only commodity trades (indigo, tea and silk); at present it settles up to 198 different types of futures and option contracts and almost two thousand UK indices. On the basis of the Financial Services Act (FSA '86) this institution has a permit to perform the function of a clearing centre for the London International Financial Futures and Options Exchange (LIFFE), the London Metal Exchange (LME), the International Petroleum Exchange of London (IPE) and the Tradepoint Stock Exchange (Tradepoint). It is subject to the regulation of the Financial Services Authority. As regards its ownership, it is a public limited company, registered in the UK, where its capital in the amount of GBP 50 million is divided among members (75%) and LIFFE, LME and IPE (25%).

Membership of the LCH by origin



Since its reorganisation in 1996 the LCH has been developing a new strategy - improving its infrastructure, developing techniques for risk management, developing the model of a clearing centre for non-equity markets. As re-

¹The LCH has 119 members, these are banks (52%), brokers (25%), industrial producers (10%) and investment houses (13%).

gards risk on the side of its partners, the LCH manages these at three levels:

1. membership criteria and the administration itself of members
2. position monitoring
3. a system of deposits

The essential criteria of membership in the LCH are the fulfilment of conditions and thereby authorisation of the subject in accordance with the FSA '86 act and other banking and financial requirements such as minimum capital adequacy, verification of the minimum amount of financial resources, as well as a bank agreement on the immediate transfer of funds to the LCH upon request etc.

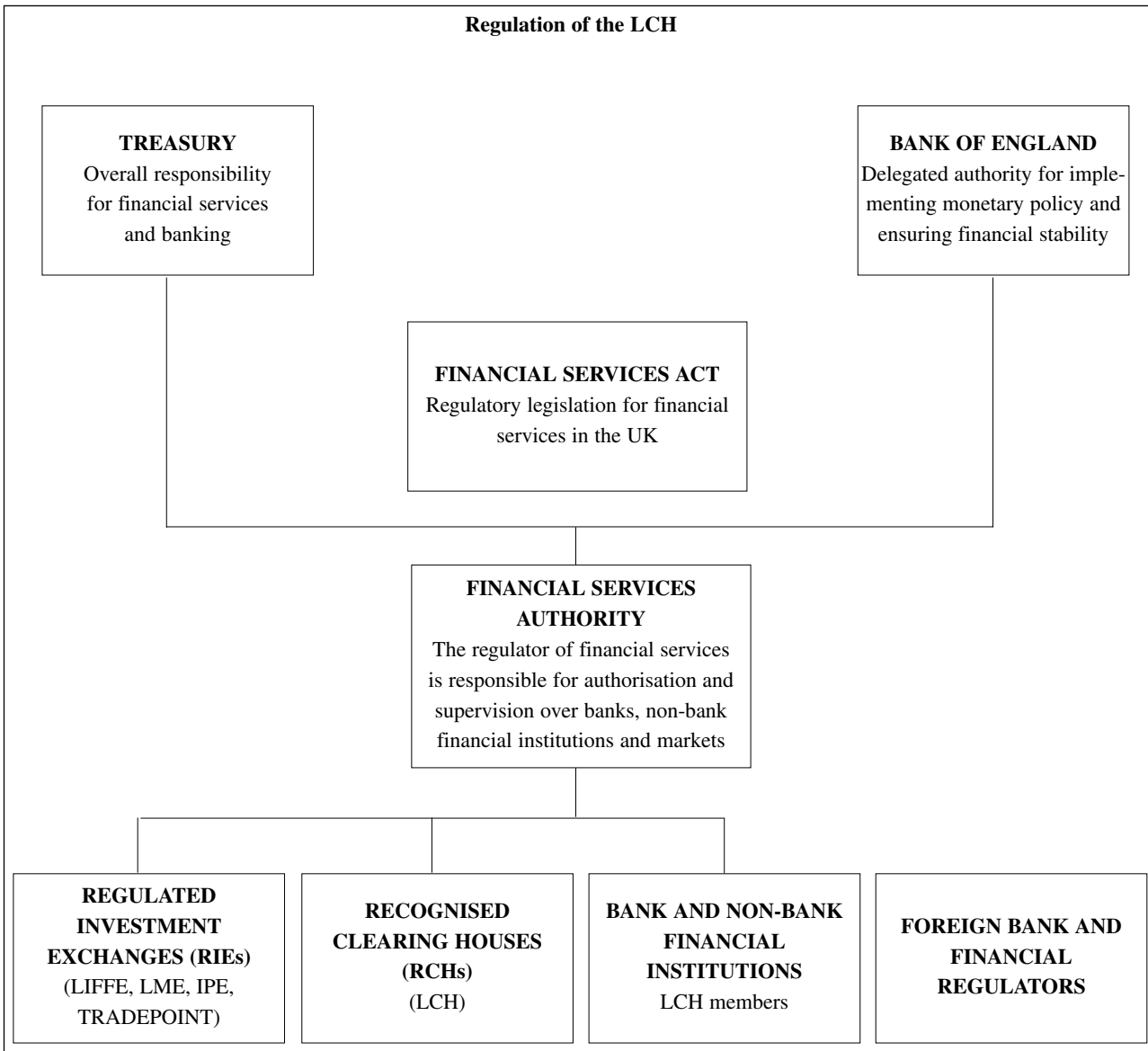
Every member must purchase at minimum one share in LCH and make a cash deposit into the so-called default fund in the amount of 150 million GBP. These deposits are re-evaluated every three months and may be altered in the case of significant changes in the clearing activity of a member. Interest is paid on the deposits at the interest rate of three-month LIBOR +1%. The default fund is used, if losses of the LCH on positions members becoming insolvent are greater than the deposit which they made into the LCH (subsequently they are permitted to supplement the deposit in the fund). If the losses are greater than GBP 150 million a special insurance facility can be used in the amount of at maximum GBP 100 million.

Position monitoring means an analysis of the risk of each member in relation to their ability to cover their deposit obligations and to fulfil delivery conditions (open interest is monitored; the methods for setting the amount of deposits in relation to price movements are determined).

The system of deposits represents daily contact with the clearing centre by means of a deposit for all open positions (even in the course of a day in the case of price movements: so-called intra day). We can identify here, a variation deposit (after concluding a trade following the re-evaluation on the basis of the concluded price) and a maintenance deposit. The LCH invests these funds on the interbank market in London - members receive interest on their initial deposit in the amount risk of London deposit rates. The rate for a deposit must be in the form of cash (USD, GBP, EUR, CHF, JPY), a bank guarantee or securities (UK Treasury Bills, Gilts, Sterling Certificates of Deposit, US Treasury Bills, Bonds, Notes, US Dollar



Diagram 1



Certificates of Deposit, Dutch Government Bonds and Treasury Bills, and similarly for French, German, Italian and Spanish Government Bonds and Treasury Bills). The Clearing House here in the case of one member takes into consideration all open positions and so determines the one resultant deposit, this process being called netting.

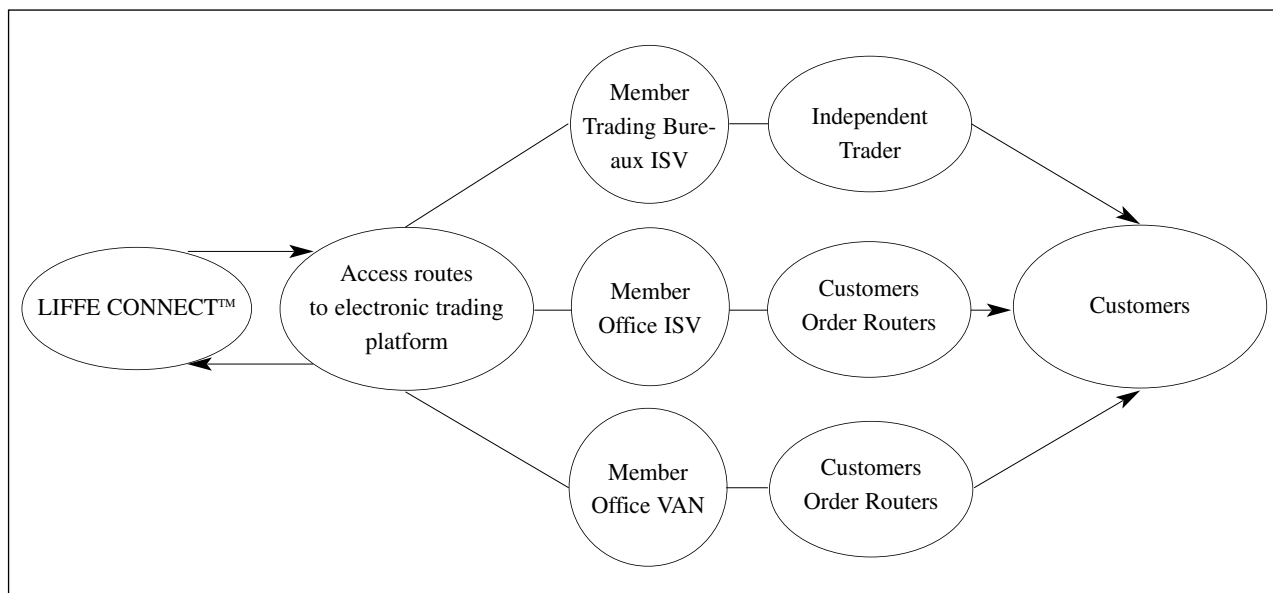
That largest client of the LCH is the London International Financial Futures and Options Exchange (LIFFE). This exchange was established in 1982 following the removal of foreign currency restrictions in the UK. Originally it was used for realising trades in futures and options for financial assets, and for interest rates denominated in the main currencies. In 1992 the Exchange merged with the London Traded Options Market (LTOM), establishing among others also equity options. In 1996 the Exchange merged with the London Commodity Exchange (LCE), expanding its range also by commodity trades.

Originally trading on to the stock exchange used the open outcry system, where traders physically met in the

exchange building to conclude a trade. Each product was traded on a special reserved area, or pit). In 1998 a programme was adopted, on the basis of which this system of trading began to transform to an electronic form – LIFFE CONNECTTM. This is an anonymous order-driven trading system. At the same time organisational changes on the Stock Exchange were made - membership and the right to trade was separated from ownership of shares in the exchange, thereby simplifying also the equity structure and enabling non-members to purchase shares in LIFFE (Holdings) plc. A shareholder thus need not be a member of the exchange. In June 2000 the exchange announced the end of the transformation in its trading system to an electronic platform and at the same time publicly declared its commitment to become the leading exchange in the world either by means of exchange trades as well as through developing new technologies for electronic trading.

The electronic trading platform is an open architecture structure, which enables a trader to acquire the software

Diagram 2 LIFFE CONNECT™



they need for their specific operation. On the one screen there is shown:

- front/back office trading
- settlement
- risk management
- order routing
- derivatives trades
- trades in cash

The first traded contract through the system was on 30th November, 1998, an individual index option. On the 2 May 2000 already all financial products were being traded through this system and by 27 November 2000 also non-financial products had arrived.

Partners of the exchange are investors in communications technologies – Battery Ventures, the Blackstone Group and Cap Gencini Ernst & Young. The exchange has close contacts with the Tokyo Stock Exchange (TSE) and the Tokyo International Financial Futures Exchange (TIFFE), which can be seen also in the LIFFE products themselves. With the aim of satisfying the needs of clients in the case of entry into LIFFE CONNECT™ outside London, the exchange adopted in March 1999 EQUANT (Global Network Partners), i.e. a highly flexible, cost-effective international network, supporting Independent Software Vendor fronts for commercial applications and so enabling access by various methods. The exchange also signed an agreement with a third party VAN (Value Added Network Suppliers) for facilitating further access, meaning that access is possible also through both the exchange network, as well as through the infrastructure network of a third party (usually through GL TRADE and Bloomberg LP). Approximately

Table 1 Overview of the LIFFE exchange financial products

| Contract Name | Futures | Futures options | One-year mid-curve option on a future |
|--------------------------------|---------|-----------------|---------------------------------------|
| 3 mes. Euro (Euribor) | yes | yes | yes |
| 3 mes. Euro (Libor) | yes | no | no |
| 3 mes. Sterling | yes | yes | yes |
| 3 mes. EuroSwiss Franc | yes | yes | no |
| 3 mes. Euroyen (Tibor) | yes | no | no |
| 3 mes. Euroyen (Libor) | yes | no | no |
| Long Gilt | yes | yes | |
| German Government Bond (Bund) | yes | yes | |
| Japanese Government Bond (JGB) | yes | no | |
| Two Year Swapnote | yes | no | |
| Five Year Swapnote | yes | no | |
| Ten Year Swapnote | yes | no | |
| Universal Stock Futures | yes | no | |
| Individual Equity Options | no | yes am | |
| FTSE 100 Index | yes | yes am + eu | |
| Mini FTSE 100 Index | yes | no | |
| FTSE 250 Index | yes | no | |
| FTSE 'Stars Index | yes | yes eu | |
| FTSE Eurobloc 100 Index | yes | yes eu | |
| FTSE Eurotop 100 Index | yes | yes eu | |
| FTSE Eurotop 300 Index | yes | yes eu | |
| FTSE Eurotop 300 Ex UK Index | yes | yes eu | |
| MSCI Euro Index | yes | yes eu | |
| MSCI Pan – Euro Index | yes | yes eu | |

am – american option
eu – european option

² From July 1987 among its products it had included on Japanese Government Bonds (JGB) and from April 1996 a 3-month future on Euroyen.

20 ISV (Independent Software Vendors) have entered into the agreement.

The Exchange is trying to resist competitive pressure also by means of an expanded product range. Besides derivative products – futures and options in five currencies and in five categories (short-term int. rates, bonds, swaps, indices, non-financial products), it offers also facilities for helping traders. Up to 98% of market activity pertains to euro-denominated short-term interest rate contracts STIR. LIFFE enables trading in more than 90 UK individual options on an index. On 29 January 2001 trading in the index Universal Stock Futures began, covering securities of the main international companies. Investment companies are more and more diversifying their portfolio through investing in commodities. At LIFFE there are for example chocolate, white sugar, call, potatoes.

On the other hand besides products the exchange also offers the possibilities for acquiring these by means of various facilities. These mainly are:

1. Asset Allocation
2. Block trade
3. Basis Trading
4. Flex© Options

In essence there is actually the possibility of diversifying risk by means of opening various or equal simultaneous trades on the LIFFE market or with corresponding cash instruments or OTC market instruments. It is necessary to mention that futures and options contracts themselves are, besides speculation and exploiting and the possibility for arbitrage, actually used for hedging.

Trading begins with the confirmation of an offer in a central book of offers, the Trading Host. This works in the system of price time priority (meaning the best offer or

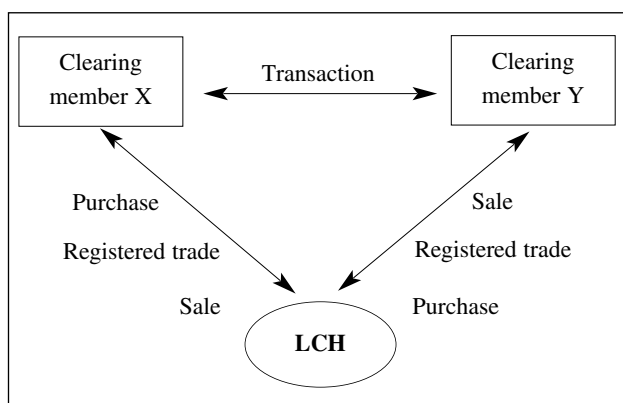
the one system, the Clearing Process System. As soon as a trade is registered, the London Clearing House (LCH) becomes a partner of the buyer and seller.

The creation of the European Monetary Union represents a significant breakthrough in the forming of an international financial market. Perhaps the greatest change, which has occurred in connection to this, is the loss of the possibility to invest in national currencies of countries participating in the euro system in the form of direct or indirect investments. On the other hand - the replacement of national currencies by the single currency also represents a decrease in foreign exchange risk for participants in international financial relations. EMU both liberalises access to trading in individual forms of assets, as well as on the other hand creating pressure for greater control and concurrently for raising the efficiency of the circulation of financial funds.

The growth in trades, the internationalisation of securities, electronic trading, and foreign mergers of exchanges opens up the issue of functionality of various clearing centres in Euroland. For the purpose of increasing liquidity on the financial market, stimulating foreign trade, lowering transaction costs as well as improving the functionality and development of the capital market itself in this zone, the European Association of Central Counter Party Clearing Houses (EACH) was charged with the preparation of principles and standards, on the basis of which there would in the framework of Euroland be created and function a single clearing centre. The basic entry criteria for the creation of such principles are the capacity for multiple currencies and multiple products, which in practice means the settlement and clearing of trades in all currencies and in all possible products which can be traded, i.e. commodities, currencies, securities, indices, derivatives³.

With regard to the number of exchanges, the number of types of contracts, turnover, currencies accepted in the clearing house, the LCH clearly dominates in Europe as well as the rest of the world. In the creation of an integrated European clearing centre this clearing house has the best prospects, therefore its effort for further more significant modernisation, efficiency, security and speed of the expanding apparatus is understandable, despite the UK's non-participation in the euro system. Money does not recognise borders.

Diagram 3 Relationship between a clearing member and the LCH



demand) and price and pro rata (the same officers have equal priority). The placing and registration of a trade is ensured by the Trade Registration System, information arrives on a real-time basis throughout the whole trading day. This provides also various facilities to members and expands these functions by coordination of trades, clearing, depositing and risk management in the framework of

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2. Chovancová, B., Jankovská, A., Kotlebová, J., Šturc, B. – Finančný trh – nástroje, transakcie, inštitúcie – 2nd edition, Eurounion Bratislava 2002.
3. LIFFE internal materials
4. web site www.liffe.com

³For example Amsterdam, Brussels, Paris use the Paris Clearnet-centre in the framework of Euronext.