

**POST-TRADING IN EUROPE:
CALLS FOR CONSOLIDATION**

1. Background discussions

The UK OFT and Competition Commission inquiries related to a potential acquisition of the London Stock Exchange have acted as a catalyst for reflection on the future of market infrastructures in Europe. Because activities and infrastructure providers are so closely linked along the trading value chain, debates have soon widened to cover, not only trading activities, but also the question of the post-market.

The Competition Commission inquiry and the debates around it have shed light on a number of key issues:

- ? First, there are strong **competition concerns** over the provision of market infrastructures: market infrastructures benefit from dominant positions, with little or no competition and silos raise potential additional issues. The UK Competition Commission correctly showed that the post-trading chain impacts any prospect for competition at the trading level. This analysis rightly led the Competition Commission to request structural (divestment) and behavioural remedies from the parties to ensure the independence of the LSE's clearing provider.
- ? Second, current fragmentation in European clearing and settlement makes it impossible to take full advantage of economies of scale and pushes up costs for users; there are strong benefits from further **horizontal consolidation** of market infrastructures and the move should therefore not be prevented. However, the risk of potential abuse of dominant position will have to be correctly managed.
- ? Third, vested interests and political debates **slow down** the process and could even prevent any progress towards a more efficient architecture for European clearing and settlement.
- ? Fourth, **users' voices** are increasingly being heard. They have a role to play in shaping the vision of a more efficient and integrated European trading and post-trading marketplace.

2. Clear objectives and deadlines set by Commissioner McCreevy

Commissioner McCreevy's speech on 13 September 2005 in Luxembourg was seen as a very powerful message and was much **welcomed** by the community of users. Indeed, we believe the

European Commission has a role to play in the on-going discussions and that the Commissioner has chosen the right approach.

2.1 Public involvement is needed

Legal and regulatory difficulties, added to financial and commercial interests and heavy investments in established platforms, create **strong barriers to change**. We therefore believe it is the role of the Commission to give a **political impetus** and to act as a facilitator for change and collective action. In this respect, we wish to recall the US experience where both the Congress and the Securities and Exchange Commission gave the impulse for the departure from vertical silos and the move towards horizontal consolidation¹.

2.2 Right approach

Furthermore, we support the following messages of Commissioner McCreevy:

- ? Cross-border trading remains too expensive;
- ? The creation of a **pan-European clearing infrastructure** would bring significant benefits in terms of increased efficiencies and cost savings, which would contribute to the decrease in those cross-border transaction costs; in addition, we believe that a similar move should occur for settlement;
- ? **Legislation** will be needed if market players cannot move forward alone.

The remainder of the document details our views on our vision for the consolidation of infrastructures in Europe, the potential obstacles and the necessary steps. The move is **inescapable** and, as pointed out by Commissioner McCreevy, there is a **collective responsibility** to deliver as quickly and as efficiently as possible.

3. The limitations of competition in post-trade organisation

Discussions in Europe around clearing and settlement have often focused on **interoperability** and **competition** between infrastructure providers. Notably, the new Markets in Financial Instruments Directive stressed the importance of open access and granted European passports for all players, in order to promote competition.

More recently, the UK Competition Commission has noted an additional remedy to the possible lessening of competition (SLC) identified, based on interoperability to foster competition. This scenario was criticised as being unrealistic and inefficient from a users' perspective². A BTA Consulting report issued in March 2005³ also indicates that interoperability was not seen as a

¹ In 1975, there were seven vertical silos. We refer to the *Background Note on the Organisation in the US Market for Clearing and Settlement*, prepared by the Cross-Border Subcommittee of the Securities Industry Association (SIA) for the European Commission, May 2005.

² "A commitment to mandate two (or more) interoperable CCPs would be impracticable and therefore not be effective in remedying the SLC and its adverse effects" (UK Competition Commission, Report on the proposed acquisition of LSE plc by DB AG or Euronext NV, November 2005, p. 10).

³ *European cross-border clearing and settlement 2005-2007, A thought leadership paper from BTA Consulting*, March 2005.

major contributor to a more efficient clearing and settlement architecture in Europe, as “*flawed on the grounds of cost benefit and risk portability*”.

Looking at the US example, regulators agreed that competition between post-trading infrastructures was of **secondary importance** compared to the overall objective of efficiency and robustness of infrastructures⁴.

We therefore argue that competition is set to remain weak in clearing and settlement and certainly **insufficient** to bring meaningful price reductions and innovations for users and customers. On the contrary, further consolidation would bring significant benefits, as detailed below.

4. Benefits from consolidation

4.1 A global trend

LCH.Clearnet and the Euroclear group were the first examples of cross-regional mergers, followed by NCSD in the Nordic countries⁵. Domestically, not long ago, Germany, Spain and Switzerland, had several CSDs which are now merged in single entities.

In the United States, the cash equities markets moved from a system of seven CSDs owned by exchanges to **one CSD and one CCP**, so that clearing and settlement for the US equities markets now takes place through the DTCC⁶. Although the process took time and is not fully replicable in Europe because of (notably) taxation and legal matters, the US example provides powerful insights into the rationale for consolidation and the vision for Europe. Other similar examples in Canada or in Asia also support this picture.

4.2 Efficiencies and cost savings

Positive network externalities and economies of scale apply for clearing and settlement:

- ? In clearing, increasing volumes of trades cleared in one CCP create **positive externalities** from two sources: first, they increase the benefits of exposure netting and second, they optimise collateral management. In a cross-border environment, through multilateral netting, the CCP reduces the number of settled trades, and consequently, reduces the costs of cross-border settlement of trades.
- ? Settlement systems benefit from strong **economies of scale**, as the incremental cost of processing volumes of transactions on a single platform is very low once the system has reached critical mass. Although the same consolidation rationale would apply to both

⁴ SIA, 2005, *op. cit.*

⁵ The Swedish CSD (VPC AB) which owns the Finnish CSD (APK) operates the two CSDs under the NCSD brand. At the present time, the OMX group owns about 20% of VPC AB but intends to reduce this stake over time. According to NCSD, the new group represents approximately 64% of equity-related transactions in the Nordic market (London Economics, “Securities trading, clearing, central counterparties and settlement in EU25 - an overview of current arrangements”, *Report by London Economics commissioned by the Competition Directorate General of the European Commission*, May 2005).

⁶ NSCC (National Securities Clearing Corporation) and DTC (Depository Trust Company) became subsidiaries of DTCC in 1999.

clearing and settlement, some in Europe give priority to the creation of a single European clearing house (BourseConsult, 2005⁷).

In the case of cross-border trades, various arrangements exist to handle the processing of clearing and settlement. However, they are complex and involve more parties, with different interfaces and procedures. A longer chain often requires manual handling of part of the process and increases direct and indirect (internal back-office) costs and risks of errors.

Pan-European consolidation will enable users to benefit from:

- ? Reduction of clearing and settlement **fees** from economies of scale, and single membership;
- ? Single **collateral pools**;
- ? **Reduction of internal costs and risks of errors** through rationalisation of users' internal back-office systems and processes, and greater automation;
- ? Last but not least, common infrastructures would allow **greater competition between exchanges** for trading.

4.3 Risk reduction

The use of a CCP has been recommended by the Group of Thirty as a tool to provide **risk reduction** and efficiency improvements for the market. The **management of risk** thus represents a critical function in a CCP.

The consolidation of regional CCPs within one integrated European CCP could raise concerns of the possible concentration of risks within it. However, such concerns are already addressed in large existing CCPs (including LCH.Clearnet, Eurex Clearing or NSCC); the new structure would require maximum transparency with regard to its financial position and procedures, including for the prevention of operational risks (see also section 7.5 below).

The European Central Bank also notes that *“overall, the risk that financial instability could be caused by or spread through settlement systems seems to be limited”* (2004). The creation of unified structures for settlement in Europe will tend to **reduce risks accruing from the transfer from one system to the other**, thus reducing overall risks.

4.4 What about Giovannini barriers?

In addition, we believe that the consolidation of platforms should facilitate further progress towards the abolition of **Giovannini** barriers⁸. Although modest progress has been made since the Giovannini barriers were identified, pan-European platforms will represent a very powerful tool, as a **driver for change** and as a **unified partner** in the discussions with national and European public authorities. Indeed, whereas domestic providers have no interest in reducing

⁷ *The future of clearing and settlement in Europe*, Bourse Consult, City Research Series n°7, Dec. 2005.

⁸ The Giovannini Group enumerated fifteen barriers to an integrated EU clearing and settlement environment. Those barriers fall in the following broad categories: national differences in technical requirements, in market practice and in tax procedures, and finally, issues related to legal certainty.

barriers to cross-border trading, pan-European platforms will push for harmonisation and reduction of both public and private barriers.

Therefore, even if consolidation cannot directly reduce administrative costs arising from the juxtaposition of complex and different legal and tax procedures, it can provide a lever to diminish those barriers and costs.

5. Silos stand in the way of pan-European consolidation

5.1 Negative effects of the vertical silos

Several examples of vertically integrated business models exist in Europe, including in Germany (the Deutsche Börse group), Spain (Bolsas y Mercados Españoles, BME) and Italy (Borsa Italiana), based on potential economies of scope between trading, clearing and settlement.

However, such economies of scope and the advantages of vertical integration are hotly debated⁹. More importantly, silos create potential for severe **competitive distortions**:

- ? Use of dominant position on one segment distorting competition at other levels,
- ? Risks of restricted access, bundling and cross-subsidies,
- ? Lack of transparency in pricing structures and unfair prices.

Additionally, silos represent a **hurdle to European financial integration** because they:

- ? Limit competition for trading by restricting participants' access to post-trade infrastructures and increasing the costs of moving liquidity,
- ? **Prevent horizontal consolidation.**

This view was supported in the joint statement of the European trade associations published in February 2005¹⁰ and in the conclusions of the BourseConsult survey conducted this fall (*op. cit.*). The report indicates that *"The majority view was that exchanges should not control the post-trade process"*. It concludes with the following: *"The existence of vertically-integrated structures is an obstacle to rationalising the European post-trade infrastructure."*

5.2 Increasing pressure from users and regulators

Pressure to dismantle existing silos is increasing, because of the reasons just outlined. Users' voices are increasingly being heard, but concerns raised by competition authorities in the UK and Italy, also clearly indicate that the vertical model is not sustainable.

⁹ See for a review, J. Tapking, J. Yang, "Horizontal and vertical integration in securities trading and settlement", *ECB Working Paper*, Aug. 2004.

¹⁰ « Statement of principles to be applied to the consolidation of stock exchange and infrastructure providers in Europe », AFEI/Assosim/FBF/LIBA/SSDA, 3 Feb. 2005.

Several patterns of development can be considered:

- ? Stricter governance aiming at ensuring free access and avoiding competitive distortions along the value chain,
- ? Toughening of competition rules at national or European level to ensure strict separation of activities between trading, clearing and settlement,
- ? Dismantling of the silos imposed by a European legislative action.

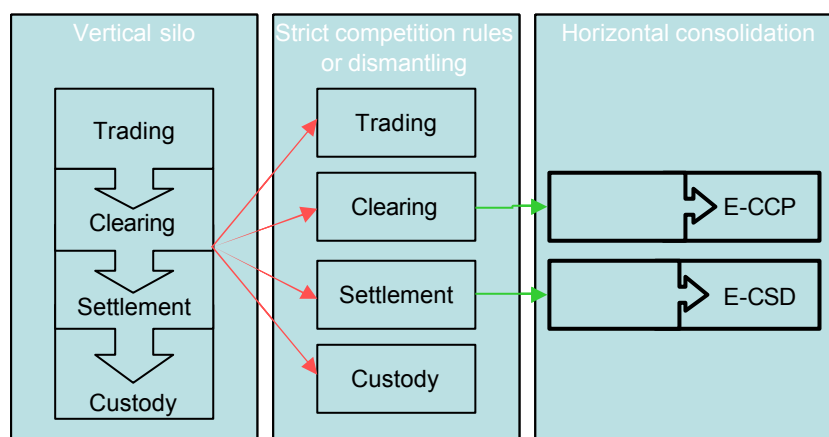
In each case, the mixture of public and private actions should be adjusted to ensure the most efficient outcome. In all cases, the changes will affect the value of the groups impacted and their prospects for development.

5.3 Integrating the future rules of the game

Infrastructure providers in Europe are private companies, whose shareholders have legal and financial rights. However, their decisions will impact the path towards integration of financial markets in Europe. Users' voices and future competition rules will have to be taken into consideration. Governance rules will have to be set up to ensure that the evolution of these collective infrastructures meets the **global objectives and needs of European financial markets** and market participants, and not only financial rationale of shareholders.

Shareholders have the power to lead the process of vertical disintegration. Indeed, if each piece of the silos (trading, clearing and settlement) is constituted as a separate entity, the move will **unlock potential for consolidation** at European level and the shareholders could receive a significant benefit.

Exhibit 1 : From vertical silos to horizontal consolidation



Vertical separation could occur differently depending on the original corporate structure of the silos:

- ? In the case of privately-owned companies (BME, BI), separation could take place through spin-offs,
- ? In the case of Deutsche Börse Group, which is a listed company, an exchange of shares could take place, to allow the listing of separate entities, followed by a delisting of the clearing and settlement activities.

Other options could be discussed, the important point being to take into account the specificities of the entities involved – as infrastructures providers -, and the overall objective sought after.

6. Scope for consolidation

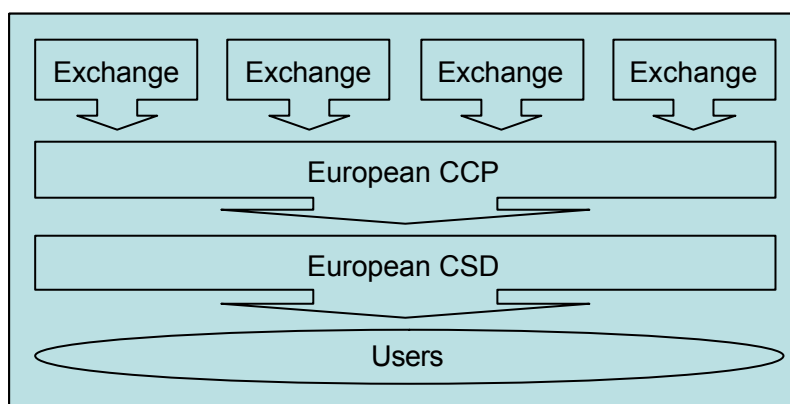
6.1 Geographical scope

Consolidation of post-trading infrastructures should include as large a number of countries as possible. However, the process will take time and effort. As a first step, LCH.Clearnet and Eurex Clearing, on the clearing side, and Euroclear and Clearstream on the settlement side, could be the two first building blocks towards pan-European infrastructures. Covering the largest markets in Europe, they will have the **critical mass** to trigger technological harmonisation and pave the way for European integration.

Consolidation should extend to other clearing and settlement providers in Europe, notably Spain and Italy¹¹. With regard to clearing, the common platform could also serve as a basis for developments in countries where a CCP does not exist yet¹².

The following picture illustrates the desirable end-state. As noted, regional consolidation might be needed first, and then followed by further unification. The most efficient infrastructure and model will emerge among the first regional clusters and will serve the basis for pan-European consolidation.

Exhibit 2: Vision for an efficient trading and post-trading landscape in Europe



6.2 Cash and derivatives

The US model remains fragmented for cash and derivatives markets. This is largely a consequence of differences in the timing of market developments, the existence of separate financial centres and separate regulators¹³. The degree of fungibility of products, especially when traded over-the-counter, also impacts the potential benefits of consolidated platforms.

¹¹ Local CCPs in Europe include Iberclear in Spain (which also provided settlement services), Cassa di Compensazione e Garanzia (CCG) in Italy. Local CSDs include Monte Titoli in Italy, CSD SA in Greece, Interbolsa in Portugal. See the report by the London Economics (May 2005) for a detailed presentation of existing arrangements and structures in Europe.

¹² Fifteen out of the 25 EU markets have established a CCP but they don't always clear the same range of products and instruments (ECB, 2004).

¹³ See SIA, 2005, *op. cit.*

In Europe on the contrary, several European infrastructures operate for both cash and derivatives (Eurex Clearing, LCH.Clearnet, CC and G, etc.). The combination brings significant benefits for users, in terms of exposure and processes. A similar model is quite acceptable for consolidated European platforms but is not the only solution.

6.3 Post-trade banking activities

In common with all the European trade associations which subscribed to the joint statement published in February 2005, we believe that keeping competition open and fair in those services where competition is possible is the best way to ensure low cost and innovation in the long term. Where a group provides both central market infrastructure services and value added services, there is a risk that it will compete unfairly.

We also believe that, to ensure a level playing field between providers, **segregation** of infrastructure services enjoying a dominant or monopoly position from other risk-based, value-added activities must be ensured, at least at the final stage of the consolidation process and preferably earlier. This segregation will prevent potential bundling and cross-subsidies from creating competitive distortions for other banking players. A further dimension, which is risk-related, also supports this view, as systemic risk tends to increase when both banking and infrastructure activities are combined in a single entity¹⁴.

Therefore, we support the view that value-added activities, subject to competitive market rules, should then be operated by a company (normally a bank) with no privileged access to infrastructures and with separate Board and management, and under prudential supervision and banking laws.

This requirement has to be taken into consideration during the process leading to the European integrated model advocated above.

6.4 A distinct rationale: The Eurobond markets

Eurobond post-trading, which has proven very efficient over the last thirty years, obeys different logic, based on large volumes, big players and an apparently efficient duopoly between Clearstream International and Euroclear plc. In order to achieve the consolidation of platforms for the equities markets, while maintaining the **status quo for the Eurobond** markets, a split between activities could be necessary. With regard to domestic corporate bonds, the European markets, although growing rapidly, are still underdeveloped compared to the US markets for reasons which are not related to clearing and settlement issues. They may not necessarily be in the scope of the first stages of the consolidation process.

¹⁴ See also, Russo & al., "Governance of securities clearing and settlement systems", *ECB Occasional Paper Series*, n° 21, October 2004: "CSDs generally do not undertake credit risk to system participants incident to their provision of core settlement services, although they may organise collateral arrangements or guarantee funds to minimize the credit risk undertaken by system participants. If, however, the operation of a securities settlement system offers in addition banking and other non-core services, such as collateralised or uncollateralised credit lines, then the CSD undertakes credit and liquidity risks" (p. 17).

7. Getting there

7.1 Competition rules

Competition rules for markets infrastructures will be decisive. They should be coordinated and/or decided at European level. The European Commission should provide input in advance, particularly with regard to the status and regulation of infrastructures operating as (natural) monopolies or having a dominant position, thereby providing visibility to all stakeholders. National competition authorities will also play an important role.

7.2 Governance

Governance provides one means by which the objectives of a structure may be pre-specified, its performance monitored and shared, and the effects of potential conflicts of interests between stakeholders minimised.

In the absence of effective competition, **strict governance arrangements**, together with close regulators scrutiny, must be implemented to avoid any abuse of dominant position and ensure appropriate risk management and fair treatment of users. As a basis, the principles outlined in the joint press release of the European associations (*op. cit.*) should be recalled.

Most examples around the world of clearing and settlement infrastructures are organised as utilities, **user-governed**. Those broad characteristics should apply to unified pan-European infrastructures.

Relevant arrangements should be incorporated in the **bye-laws** of the new merged entities and implemented:

- ? Clear and transparent rules for **decision-making**, ensuring a proper focus on price efficiency and cost reduction, together with sufficient attention to **risk management**,
- ? Composition of **Boards** of Directors and Advisory Committees, based on the following principles:
 - o Majority of users,
 - o Proper representation of types of users and geographies covered (in accordance with the importance of the different financial communities and marketplaces)
 - o Reserved seats for independent directors.
- ? Rules for **profit allocation, depending on the capital structure defined** (see following section).

Relevant independent audits on access, prices and services should also be regularly conducted to ensure there is no abuse of dominant position. Open consultations, complementary to the work of the advisory committees, should also be organised.

7.3 Capital

The consolidation process in European clearing and settlement infrastructures will require sizeable changes in ownership. Given the principles for strong user governance outlined in the previous section, two options could be considered:

- ? **User-owned, user-governed entities**, which could be organised as cooperatives, or as private companies; ownership and profit allocation would be roughly aligned with usage; new users would be allowed to participate in the capital of the entity;
- ? **User-oriented entities with open shareholdings**: users could remain a part of the shareholders base of the clearing and settlement infrastructures, but other investors (possibly including exchanges, with proper limitations) could participate:
 - o **Clear and transparent financial policies** will then have to be defined, providing guidelines for the sharing of financial surpluses between owners and users and giving **priority to users**.
 - o More specifically, returns for users should be based on usage, with clearly defined calculations. Sufficient returns for non-user shareholders should be agreed on in advance and capped. Two sets of shares could therefore be defined.

7.4 Systems

Technological aspects will represent a significant challenge. In order to benefit from scale economies and synergies, users will have to migrate to one **common system**, which will give rise to costs for both users and providers. **No ex-ante assumption** on the preferable systems should be made. Choice will be made based on feasibility studies and cost-benefit analysis.

7.5 Oversight and supervision

Both market regulators and central banks are concerned by the soundness of post-trade processing of securities because of potential systemic risks. In the case of regional or European operators for clearing and settlement, oversight and supervision will remain challenging in the absence of proper arrangements. The case of LCH.Clearnet, which faces over twelve regulators in five different jurisdictions, shows the complexity of the European supervisory environment. Specific arrangements will have to be investigated. The question of the country of the legal home of the new entities should also be considered.

8. Conclusions

8.1 Role of the European Commission

Efficient securities trading platforms and clearing and settlement infrastructures are key for the integration and efficiency of financial markets and the reduction of transaction costs. To succeed in building the optimal outcome for European financial markets – and in a reasonable timeframe –, private and public stakeholders will need to continue to work together with defined objectives and clear guidelines.

The European Commission is adopting the right approach. As users, we further support its involvement through:

- ? The definition of strict governance and competition rules for infrastructures providers,
- ? The imposition of the unbundling of the vertical silos if private stakeholders do not start the process on their own,
- ? The support for horizontal consolidation and the emergence of single or dominant pan-European infrastructures both for clearing and settlement, and the provision of a favourable environment.

Vigorous actions of the public authorities are requested to ensure that infrastructure providers conform to competition policy and the law. There must be a voice for users in the governance and users need to fight for it.

8.2 Exchanges

Clear governance rules, ensuring users are given a top priority, should also apply to exchanges which are in the position to benefit from their dominant positions. With stricter governance and regulatory scrutiny, distinction between normal profits and normal valuation of the listed exchanges and excess profits arising from monopoly rents will appear.