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Settling for efficiency – A framework for the European securities transaction industry ☆

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Abstract

Despite a lot of restructuring and many innovations in recent years, the securities transaction industry in the European Union is still a highly inefficient and inconsistently configured system for cross-border transactions. This paper analyzes the functions performed, the institutions involved and the parameters concerned that shape market and ownership structure in the industry. Of particular interest are microeconomic incentives of the main players that can be in contradiction to social welfare. We develop a framework and analyze three consistent systems for the securities transaction industry in the EU that offer superior efficiency than the current, inefficient arrangement. Some policy advice is given to select the 'best' system for the Single European Financial Market.

JEL classification: F36; G28; G34; L22; P51

Keywords: Trading; Clearing; Settlement; Straight-through processing; Central counterparty; Consistent systems

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1. Introduction

Different and sometimes intertwined forces are at play in the European securities transaction industry stemming from the motives of the different opponents. These are often influenced or even biased by strategic deliberations and the desire to advance the industry structure to the own advantage. A hotly debated issue is whether horizontal or vertical integration is more suitable to achieve efficient capital markets in Europe. This can be discerned from the on-going consolidation efforts of Deutsche Börse pursuing both the London Stock Exchange and, more recently, Euronext. Both attempts failed so far, because of concerns about substantial differences in the business models with regard to the extent of vertical integration in a combined group. As a consequence, a merger of both the French and the English stock exchange with American counterparts – the New York Stock Exchange (NYSE) and the NASDAQ, respectively – seems more likely at the moment.

This paper sheds some light on these issues by applying economic tools to identify the underlying economies in the industry and to comment on an efficient securities transaction system for the European Union. Our contribution is to provide a framework for the analysis of this industry which interprets efficiency in a broad sense and offers policy advice by proposing consistently configured trading, clearing, and settlement systems (TCS-systems) that achieve high levels of efficiency from the perspective of a benevolent organizational designer.[2]

The result of restructuring and innovations in recent years is a securities transaction industry in the European Union (EU) that is still a highly inefficient and inconsistently configured design for cross-border transactions. Many EU politicians eagerly promote the completion of the Single European Market, but – few exceptions aside – the industry structure still resembles closely the former fragmented market structure of largely independent organizations operating along national lines. This causes higher costs in the handling of cross-border securities[3] which ultimately translates into higher costs of capital – a significant competitive disadvantage for European firms compared to companies in the USA.

Industry experts point to several aspects that impede the realization of an efficient securities transaction system. While trading is widely seen as efficient, clearing and settlement processes across different countries are still too costly. The fragmented industry structure which does not allow for capturing the significant benefits from scale, scope, and network effects is paralyzed by several obstacles to consolidation. Besides political, cultural, and legal barriers among the different countries, the motives of the market participants such as infrastructure providers and direct users sometimes contribute to the impediment of consolidation efforts and thus prevent a socially optimal solution.

What has become increasingly visible is the lack of a common communication standard among service providers. This could be a result of vertically integrated providers with incompatible information dissemination standards and post-trading routines. As a consequence, the typical cross-border trade requires substantial interaction among the pertaining different trading, clearing, and settlement systems which can only be effectively dealt with by additional intermediaries such as (sub)custodians. This extends the length of the value chain and thereby increases the costs for the investors. More interaction require-

[2] See Weiß (2007) for theory and practice of organizational design.

[3] Lannoo and Levin (2001, pp. 14–30) and Deutsche Börse Group and Clearstream International (2002, pp. 15–29) present a cost analysis of cross-border transactions.