



## Mergers in Post Trading Markets

Can merging clearing houses increase efficiency?

The news that LCH Clearnet and the US Depository Trust and Clearing Corporation (DTCC) have held talks about a merger brings to the fore the differences in the costs of post-trading services between the EU and US. It is a difference attributable not only to scale but different business models. Whilst many welcome the potential for cost reduction that a large EU clearing house might bring, the implications for competition need to be considered. Here we briefly set out the differences in the US and EU post-trading models, and recent competition and regulatory developments in this area.

### Post-trading Services

Post-trading services - clearing, settlement and custodian services - provide the infrastructure for trading securities. LCH Clearnet and DTCC are networks that, within Europe and the US respectively, connect counterparties to a securities trade and enable them to clear and settle their transactions. Their clearing function ensures that counterparties are solvent and able to carry out the transaction. Once trades are cleared, they are then settled when securities and payment are irrevocably exchanged, and then held in safekeeping (custodian services). A merger between LCH Clearnet and DTCC would enable a single operator to clear and settle transactions between EU and US counterparties – opening the way for cheaper costs of trading across the Atlantic, as well potentially increasing efficiencies in cross-border EU trading.

### Scale economies and network effects

Post-trading services exhibit strong scale economies as well as network effects. If all traders clear and settle their transactions through the same provider, the costs are reduced for all. This not only arises from spreading costs over a large volume of turnover but may also arise from network effects. A group of traders using the same clearing and settlement provider may transact more frequently with each other than with counterparties using other clearing and settlement providers. Therefore an increase in the number of counterparties using a particular post-trade service provider benefits all by increasing the opportunity (and reducing transaction costs) for low-cost trading within the group, contributing to increased liquidity.

### The horizontal model

Economies of scale arising from clearing and settling large volumes of trades suggests that a horizontal model of post-trading services, similar to the US model, would help improve efficiency and deliver lower prices in Europe. However, dominance in the provision of such services may reduce the scope for innovation. This effect may be more pronounced if the entity is operated under “not for profit” mutual ownership. As the European securities trading market has shown, the scope for product and service innovation was not tapped until stock exchanges became de-mutualised. Demutualisation of European exchanges, combined with increased competition between trading platforms, has delivered better quality and more differentiated services.

### The EU market for post-trading services

The DTCC has for some time supported the creation of a pan-European central counterparty based on the US model. European exchanges, such as Deutsche Boerse, have however spearheaded the campaign for vertically integrated, country-based “silos” establishing interconnectivity for cross border trading and minimising the costs of domestic trading through a single trading, clearing and settlement infrastructure. The merger of Borsa Italiana and Monte Titoli follows the vertical model as well as recent announcements by the London Stock Exchange and Liffe that they are considering providing their own clearing and settlement services.

On the other hand, Euronext has adopted a horizontal business model to create a cross-border exchange. Euronext trades are cleared through post-trading platforms provided by LCH Clearnet and Euroclear. Deutsche Boerse has recently sought permission for Eurex, its clearing and settlement arm, to operate in London. This is seen by many as opening the door for competing clearers to link to Deutsch Boerse’s cash equities and derivatives trading platform as the price for operating in London.

The EU Internal Market Commissioner, Charley McCreevy, has consistently criticised the high costs of clearing and settlement in the EU, both cross-border and relative to the US. The industry has responded through

establishing a voluntary code of conduct aimed at improving inter-operability and bringing about greater integration. However, this move has according to Mr McCreedy not delivered the expected benefits. This is because in Europe post-trading services remain fragmented and high-cost relative to the US for reasons that cannot be solved overnight. These include:

**Different laws and regulations -** Unlike the US, which has a single set of legal and regulatory conditions, the markets in Europe have differing national laws, regulations and technical requirements making it more costly and difficult to transact across borders than within national boundaries. Harmonising these factors will take time unless the European Commission forces the hand of member states through directive tackling interoperability, non-discrimination and transparency issues.

**Different ownership model -** The European ownership model is different from the US. The US DTCC is user-owned while EU clearing and settlement providers are mostly in private hands operating on a for profit basis. Whilst the mutual model may favour lower cost (perhaps at the expense of innovation and investment) the EU model may better promote product and service differentiation but at a higher cost.

**Complex cross-border trading -** EU cross-border trades can be highly complex. Where no direct link exists between depositories, investors are forced to use agents either directly or through an international central securities depository (ICSD) which raises the costs. Such links are difficult to establish because of technological, legal, regulatory, tax and cultural differences between national markets. It is also the case that agent bank and ICSD fees include additional services provided to the investor. This makes a simple comparison of US and EU fees invalid as it is not comparing apples with apples.

**Scale effects -** The most obvious difference in costs is the large volume of trades in the US, relative to the EU. The US market is characterised by a larger number of retail investors, compared with the EU. Retail investors' requirements are usually less sophisticated than those of institutional investors, thus contributing to lower average transaction costs compared with those in

Europe. Again, simply comparing post-trading costs in these two markets is not comparing like with like. Even within Europe, financial centres such as London and Frankfurt will have different costs due to the differing type of transactions. So-called market-makers, such as banks, trade frequently but typically incur lower post-trade costs than investor-transactions. Furthermore, fees are sometimes bundled or traders face a combination of annual as well as transaction charges. It is therefore very difficult to compare the costs of transactions unless all these differences are taken into account.

The European Commission and market participants are addressing these factors. The key drivers of market participants' actions are technology consolidation and harmonisation of market practices aimed at generating large scale economies and reducing risks and costs for the market. These measures may go some way towards reducing the price of cross-border trades but it may take time to reduce cross-border trading costs to those within national borders and even longer to reduce the costs of EU trades with those of the US.

#### **Will the merger increase efficiency?**

A horizontal merger between LCH Clearnet and DTCC is likely to be welcomed by banks who would like to see a low-cost DTCC type model emerge in Europe. However, in assessing efficiencies it is important to look beyond those which simply reduce average costs. Efficiencies which reduce variable or marginal costs are more relevant to the assessment of merger benefits than efficiencies arising simply from spreading fixed costs over a larger volume of transactions.

#### **Conclusions**

Horizontal mergers in post-trading markets will improve efficiency but these improvements will need to be substantial, timely and passed through to end users. Increased competition between vertical silos and horizontal clearers suggest that these service models can co-exist in providing traders with choice as well as lowering costs and promoting innovation.

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