Consolidation in the securities settlement industry

The introduction of the euro has accelerated the consolidation process in the securities settlement industry within the euro area: investors no longer face currency risks with regard to their euro area holdings and are increasingly diversifying their euro portfolio. Developments in technology and legal harmonisation at the European level are also emphasising the need for further consolidation. In this context, competition and network externalities are further increasing the pressure for a more integrated and efficient infrastructure at the EU level, i.e. the integration of stock exchanges, trading platforms and electronic networks, market practices and contracts, and clearing and settlement facilities. This fourth potential area of integration – clearing and settlement facilities – constitutes the main focus of this article.

The increased homogeneity of the euro area securities markets, and particularly the markets for debt instruments, has progressively altered the investment behaviour of global investors, which are increasingly considering the euro area securities markets as a single securities market. In order to meet investor demands, market initiatives are being developed to further integrate the securities settlement infrastructure within the EU.

The Eurosystem has taken action to ensure the soundness and efficiency of euro area securities settlement systems and to ensure equal treatment of euro area institutions in the use of collateral. Guided by these objectives, its stance is to promote the necessary integration of the securities settlement infrastructure.

1 The euro area securities settlement infrastructure

What are securities settlement systems?

Securities settlement systems (SSSs) are systems which mainly provide custody services and final delivery of securities from the seller to the buyer. When securities are traded in exchange for funds, SSSs also ensure the smooth transfer of the related funds in the relevant payment system. In other words, market investors use the services of SSSs in order to discharge the obligations which they assume when buying or selling securities. As such, SSSs represent one of the basic infrastructures of financial markets.

In the past, the transfer of securities involved the physical movement of paper-based certificates. However, developments in technology have enabled SSSs to issue and transfer securities by simple electronic book entry (registration in accounts). Another important achievement has been the establishment of a link, for safety reasons, between the delivery of securities and the settlement of related funds, through the implementation of special mechanisms (called delivery versus payment (DVP) facilities). DVP facilities allow for the simultaneous transfer of funds and securities in the relevant payment and securities settlement systems.

Who supplies securities settlement services?

Securities settlement services are supplied by three kinds of institutions: domestic central securities depositories (CSDs), international central securities depositories (ICSDs) and custodians. The term "SSS" refers to both domestic CSDs and ICSDs.

In 1997 there were 21 domestic CSDs in the 11 countries of the euro area. This was the result of differing historical, institutional, technical and legal environments, as well as of the existence of different currencies. In most euro area countries one single CSD supported the activity of the entire securities industry, while in some countries the role of each CSD was limited to a certain segment of the market (settlement of public debt, equities, corporate debt). Domestic CSDs have thus enjoyed a monopolistic position, which in many cases was protected and defined by law. They have served the needs of the local market which they were designed to support.

These national features of most domestic CSDs have led to a fragmentation of the industry, which was thus unable to adequately serve the needs of participants willing to operate across EU markets. Cross-border transfers of securities in the EU have therefore relied extensively on the use of alternative channels, namely custodian banks or ICSDs.

Custodian banks are intermediaries which provide foreign investors with custody and settlement services in their domestic CSD(s). The ability of local custodians to facilitate communication between foreign banks and domestic CSDs and to provide local expertise has greatly contributed to the development of the cross-border trading of securities over the past 20 years. Global custodians (GCs), i.e. custodians which have extended their range of services in order to cover several markets, use a network of sub-custodians (local agents, including their local branches) to provide institutional investors with a single gateway for settling their cross-border portfolio in many countries. Although GCs also provide internal settlement of securities in their own books, they specialise more in the custody function and do not reach the level of turnover of SSSs.

The two ICSDs in the euro area, Euroclear and Cedel, have established direct and indirect links (mainly through local custodians) with SSSs in many countries. In achieving a "critical mass" of participants and assets, these institutions provide settlement of internationally traded securities in their own books.

Although there is a certain overlap (and therefore competition) between the services provided by GCs and ICSDs, the two kinds of institutions are to some extent complementary. On the one hand, GCs provide some relevant services to ICSDs. (In particular, they enable ICSDs to establish links with local markets and domestic CSDs, and act as correspondents of ICSDs for funds settlements.) On the other hand, GCs are the major shareholders and the major participants in the ICSDs.

Thus, the three major categories of supplier in the clearing and settlement industry (domestic CSDs, ICSDs and GCs) have so far each more or less served their own particular business area. Domestic CSDs serve the local market, ICSDs serve the larger investors in the international markets (including GCs) and GCs serve smaller investors and act as intermediaries between domestic CSDs and global investors (including the ICSDs).

What is driving the industry towards integration?

Integration processes between providers of these services and products are generally driven by economies of scale and scope.

Economies of scale stem from the need for service providers to create a "critical mass" of customers in order to recover the heavy investments needed in information technology and in the establishment of efficient communication networks. To the extent that SSSs are successful in attracting a significant number of issuers and participants, these fixed costs may be spread over a wider number of transactions and services can be provided at a low cost. Greater integration of different systems would enable service providers to benefit from further economies of scale, thereby reducing expenditure related to trade, settlement and custody services.

Economies of scope stem from customers' requests for a wide range of products and services at a relatively low cost. Two integrated stock exchanges or SSSs would be able to develop new products and services at a lower unit cost than if they were acting alone. The integration process would allow the provision of a wide range of services without any need for customers to set up different interfaces and to implement different procedures for reaching different markets.

Using a single point of entry to one system, a participant can, at a relatively low cost, have access to different segments of the securities markets, both at the national and at the international level.

What makes the current consolidation process in the euro area different from those of the past is a combination of new factors which emerged in Europe in the late 1990s: the introduction of the euro, the implementation of the European Investment Service Directive (ISD) and, in a global context, the intensified impact of technology.

The introduction of the euro has eliminated currency segmentation, which was one of the main reasons for fragmenting listing, trading and settlement in countries of the euro area. The euro is having an impact on the demand side of stock exchange business, by increasingly making similar European securities almost perfect substitutes. The euro has also reduced spreads between countries and will induce investors to assess risks associated with securities on the basis of the quality of the signatures of the issuers, rather than their countries, causing a substantial reorganisation of the asset management industry. Moreover, Economic and Monetary Union (EMU) has already caused the merger of the large-value payment systems in the euro area (through the establishment of the TARGET system) and has resulted in the emergence of an integrated area-wide money market (see the article entitled "TARGET and payments in euro" in the November 1999 issue of the Monthly Bulletin). The need to collateralise many of the money market transactions provides a further incentive to the cross-border use of securities in the euro area.

This increased homogeneity of the euro area securities markets, and particularly of the markets for debt instruments, has progressively altered the investment behaviour of global investors, which increasingly view the euro area securities markets as a single securities market. This will increase the liquidity of some selected instruments, transforming them from domestic instruments to benchmark instruments for the entire euro area. This will also have an impact on major service providers, as they will all endeavour to offer services related to these benchmark instruments.

As a result, the introduction of the euro has intensified the competition between different service providers in the euro area. It has removed the differences between domestic and cross-border transactions within the euro area. This has provided a further incentive for domestic SSSs to establish a link with one another in order to provide the same range of services throughout the euro area.

The ISD is a second factor which has led to the process of consolidation within the securities settlement industry. Its key element is the introduction of a "single passport" policy for market participants, which allows them to access screen-based trading systems. In fact, it allows each market participant in a regulated or organised domestic market to be recognised in the regulated or organised markets of other EU countries. It also offers members of these markets remote access to regulated or organised markets in other EU countries without their having to comply with the specific regulatory regime of the "host" country.

Finally, advances in technology allow stock exchanges and settlement systems to overcome differences in location, with the possibility of offering remote access to financial intermediaries from any location in Europe. This eliminates another reason for the fragmentation of securities listing among different stock exchanges. Advanced technology also decreases the cost of cross-border data transmission, thereby making the implementation of links between stock exchanges and SSSs easier.

In summary, these factors have modified the competitive position of national securities service providers, such as stock exchanges and SSSs, transforming them from locally protected institutions to competitors in a cross-border context. Under market pressures, the overly fragmented SSS industry in the EU is now engaged in an important consolidation process, which is taking place in two parallel phases.

The first phase is known as *vertical integration*. According to this process, the institutions in charge of securities trading, clearing, settlement and custody become increasingly integrated, very often through a holding company which manages a single system for debt and stock securities, traded on the spot and derivatives markets. This process started before the introduction of the euro and is currently well advanced in France, Germany, the Netherlands and Austria, whereas in other countries the progress has been slower.

The next phase, currently under way, is *horizontal integration,* which has accelerated since the start of Stage Three of EMU. It means a higher degree of cross-border integration and co-operation between institutions providing similar services and products.

2 The role of the Eurosystem

Objectives of the Eurosystem

The Eurosystem has two objectives in the field of SSSs.

The first is to promote the soundness and efficiency of the euro area SSSs. Central banks are primarily concerned with the smooth functioning of these systems, because of their link to payment systems and monetary policy. Their link with payment systems stems from the fact that most securities transactions also involve the settlement of funds. As a result, banks include the payment flows stemming from securities settlement in their intraday liquidity management. If these funds are not delivered, or not delivered on time, payment systems could become gridlocked. The development of DVP facilities has, on the one hand, reduced credit risk and, on the other, increased the liquidity risks which may arise in the event of a failure to deliver securities, in particular when settlement occurs in real-time gross settlement (RTGS) systems. Furthermore, since the liquidity in the TARGET system depends on intraday credit, which the Eurosystem only grants against collateral, TARGET would be blocked if securities were not delivered to the Eurosystem on time.

The Eurosystem's monetary policy operations are also fully collateralised and therefore rely heavily on the smooth delivery of securities to the Eurosystem. Against this background, the efficient and secure functioning of the securities settlement framework is important for the fulfilment of the Eurosystem's monetary policy objectives.

The second objective which the Eurosystem endeavours to achieve is to ensure equal treatment of institutions located in the euro area when accessing central bank credit. Before Stage Three of EMU most credit institutions could only use their domestic portfolio to obtain central bank credit. Now all collateral eligible for use either in monetary policy operations or in obtaining intraday liquidity in TARGET is available to all market participants, irrespective of where the collateral or the participants are located in the euro area. In meeting this second objective, the Eurosystem promotes the necessary integration of the securities settlement infrastructure. An efficient infrastructure will also promote a deepening of the markets, making the euro area financial markets more liquid and reducing operational risks.

Action taken by the Eurosystem

In pursuing the objectives described above, the Eurosystem followed two main courses of action before the start of Stage Three of EMU. It defined standards for the use of SSSs and the links between them in Eurosystem credit operations. It also established the correspondent central banking model (CCBM).

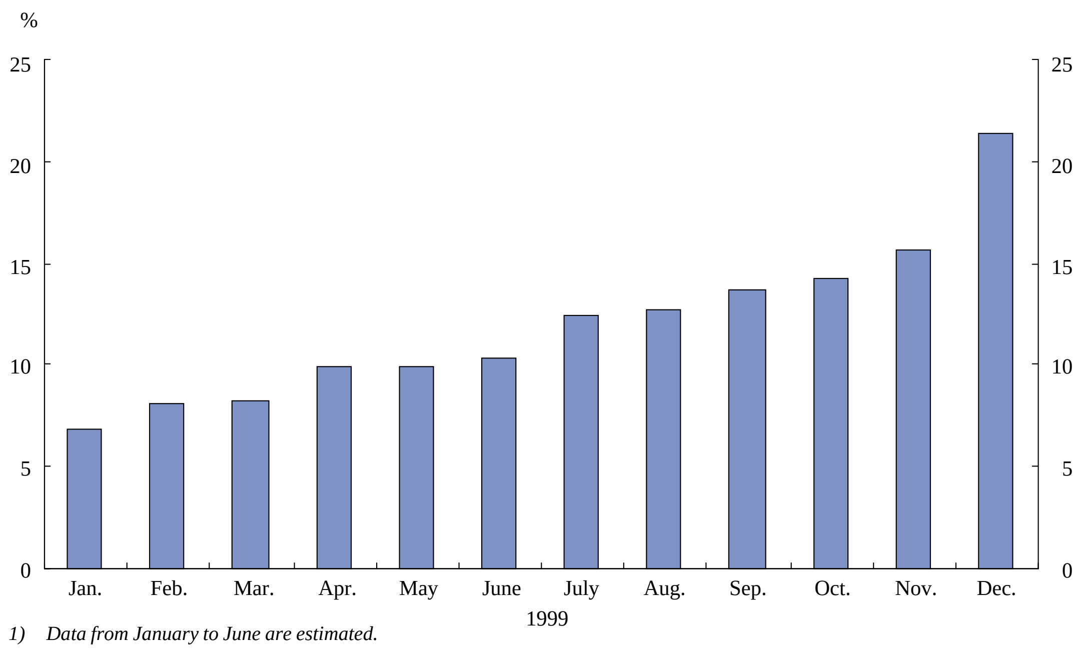
The European Monetary Institute's document entitled "Standards for the use of EU securities settlement systems in ESCB credit operations" was published in January 1998. It reflects a strong preference for clear legal arrangements, settlement in central bank money, strict limitation of custody risk and intraday finality with delivery versus payment (DVP). The need for all systems to apply the same high standards of safety and efficiency stems both from the necessity to ensure a level playing-field among the counterparts of the Eurosystem and from the need to protect the Eurosystem from assuming inappropriate risks.

The CCBM is a mechanism whereby central banks act as securities custodians for one another. It was created as an interim solution to allow all the counterparties of the Eurosystem to use all eligible assets, irrespective of where in the euro area the collateral or the participants are located. In providing a procedure for the use of the foreign collateral for central bank credit, the CCBM has enhanced the possibility for credit institutions to distribute their portfolios across the euro area. The CCBM never intended to compete with market solutions which enable counterparties to hold cross-border assets. It should not, therefore, be seen as a permanent alternative. It is not the intention of the Eurosystem to maintain the CCBM once the market has developed alternative solutions which cover the whole euro area and meet the Eurosystem's standards mentioned above.

Following this course of action, statistics reflect that by December 1999 21.1% of the eligible collateral held by the Eurosystem monetary policy operations was issued in a country other than that of the counterparty which provided it. In some countries more than half of the collateral provided to the national central banks is foreign collateral. This figure has been increasing since the start of Stage Three of EMU (see Chart 1).

Chart 1

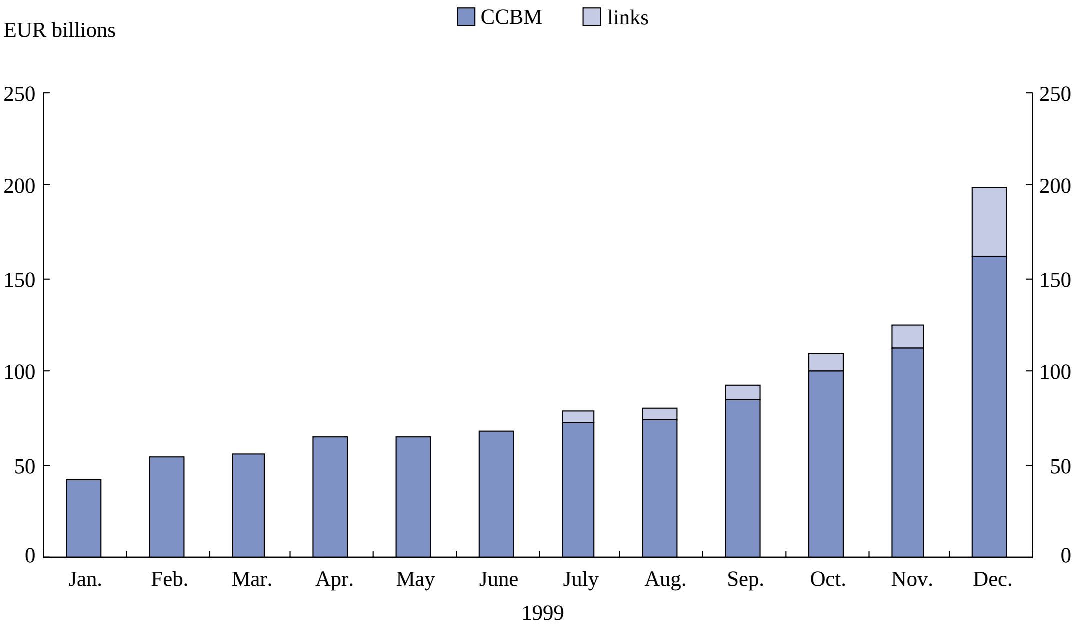
Cross-border collateral as a percentage of the total collateral held by the Eurosystem [1)]



1) Data from January to June are estimated.

Chart 2

Total cross-border collateral held by the European System of Central Banks



Counterparties of the Eurosystem may use two different channels to deliver cross-border collateral to their national central bank (e.g. a Dutch bank using Belgian OLA as collateral for a monetary policy operation): either the CCBM or the links between SSSs which comply with the standards.

By December 1999 collateral worth EUR 162.7 billion was held through the CCBM, while EUR 35.8 billion was provided through links (see Chart 2). Progress in the consolidation of the SSS industry in the euro area is expected to progressively reduce the level of recourse to CCBM transactions.

The position of the Eurosystem with regard to consolidation of the industry

The consolidation of the securities settlement industry is under way. In the field of payment systems, TARGET allows the real-time transfer of cash between any of the 5,000 participants throughout the EU. However, even today, it is no easier for a euro area bank to settle trades denominated in euro than for it to settle trades in other currencies. Market participants are keen to see a further consolidation of the securities settlement industry in order to save costs. They have already made it clear that they wish to be able to settle all their securities transactions in euro from a single gateway. The Eurosystem understands their interest in this issue. It also recognises the need for a monetary system with an infrastructure for securities settlement which is as rational and efficient as that of other monetary areas (e.g. United States).

The first year of Stage Three of EMU has already seen a rapid increase in consolidation. Some projects have already been put forward by the industry and their development is being followed closely by the Eurosystem. It is not yet clear which solution will prevail or how long it will take to achieve consolidation. In this context, neutrality and efficiency are the Eurosystem's guiding principles.

The neutrality of the Eurosystem means that it will not interfere with the market competition between systems, financial centres and categories of banks to provide a more integrated solution. It also means that the Eurosystem will avoid any "policy bias" which could favour one particular type of integration. The neutrality of the Eurosystem does not mean giving "a bit to everyone"; nor does it mean choosing a particular model (or network) for cross-border securities management proposed by the industry. Such a decision should indeed be left to the market. Rather, neutrality means that the Eurosystem clearly and openly defines the standards which it deems necessary in order to allow maximum efficiency and minimum risk, and removes potential obstacles to the consolidation process.

With regard to efficiency, the Eurosystem will support consolidation of, as well as competition within, the securities industry and, thus, the integration of euro area money and financial markets.