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NO. 375 / JULY 2004

ECB-CFS RESEARCH NETWORK ON  
CAPITAL MARKETS AND FINANCIAL  
INTEGRATION IN EUROPE

**GUESS WHAT:  
IT'S THE  
SETTLEMENTS!**

by Thorsten V. Koepl  
and Cyril Monnet





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by Thorsten V. Koepl <sup>2</sup>  
and Cyril Monnet <sup>3</sup>

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<sup>2</sup> European Central Bank, Kaiserstrasse 29, 60311, Frankfurt am Main, Germany, e-mail: [thorsten.koepl@ecb.int](mailto:thorsten.koepl@ecb.int)

<sup>3</sup> European Central Bank, Kaiserstrasse 29, 60311, Frankfurt am Main, Germany, e-mail: [cyril.monnet@ecb.int](mailto:cyril.monnet@ecb.int)

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**Address**

Kaiserstrasse 29  
60311 Frankfurt am Main, Germany

**Postal address**

Postfach 16 03 19  
60066 Frankfurt am Main, Germany

**Telephone**

+49 69 1344 0

**Internet**

<http://www.ecb.int>

**Fax**

+49 69 1344 6000

**Telex**

411 144 ecb d

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## Abstract

Exchanges and other trading platforms are often vertically integrated to carry out trading, clearing and settlement as one operation. We show that such vertical silos can prevent efficiency gains from horizontal consolidation of trading and settlement platforms to be realized. Independent of the gains from such consolidation, when costs of settlement are private information, there is no mechanism that achieves the merger of the vertical silos in a way that trading and settlement are produced efficiently after the merger. Furthermore, we show that such an ex-post efficient merger can always be implemented by delegating the operation of settlement platforms to agents.

Keywords: Clearing and Settlement; Mechanism Design; Horizontal and Vertical Integration

JEL Classifications: C73, G20, G34, L22

## Non-technical summary

Clearing and settlement systems have as of lately received a lot of attention in the context of financial integration of the euro area. The Giovannini Reports (2001) and (2003) discovered sizeable transaction costs and risks in the current clearing and settlement infrastructure that prevent efficient cross-border trading within Europe. It is therefore argued that the consolidation of this infrastructure is the key element for realizing large efficiency gains inherent in financial markets integration.

We demonstrate in this paper, however, that such a consolidation does not necessarily lead to an efficient financial market organization. In particular, we find that it is impossible to reap the full gains of horizontal consolidation if trading, clearing and settlement take place in vertically integrated firms and costs for clearing and settlement are private information. Furthermore, we show that breaking up these vertical silos and inducing competition in the areas of clearing and settlement can realize all efficiency gains from consolidation.

Our model considers two players each operating a vertically integrated firm. These firms offer trading as well as clearing and settlement of trades. They contemplate a consolidation of their trading and settlement activities, according to which they would pool their technology. We call such consolidation a merger. A merger between the firms is beneficial since it increases overall profits due to two reasons. First, we assume that the merger increases the joint demand for trading of the two firms and, hence, generates higher joint revenue. Second, the costs for settling trades can be different across firms. Hence, a merged firm can settle trades at the lower cost of the two firms. We assume that the costs for settling trades are private information of the players.

Using methods from mechanism design we show that there is no mechanism that allows the players to merge the vertically integrated firms in a way that trading and settlement are produced efficiently after the merger. Interestingly, this is independent of the overall gains in revenue that are obtained from increasing overall demand for the merged firms. It is important to emphasize that this result is not about the possibility of a merger per se, but about achieving an efficient merger, i.e. a merger that realizes all possible benefits associated with the merger.

We offer two ways to overcome the problems inherent in the vertically integrated structure. First, if a subsidy is available to vary the overall gains from merging, the incentives to reveal the costs can be restored. Provided the gains arising from additional demand are large, the required subsidy can even be negative which is equivalent to taxing the merger.

The second way is a market solution and is based on vertical disintegration. Here each player delegates the operation of his settlement platform to an agent which we assume to be an insider, i.e., we assume that the agent can observe the true cost of settlement. The players give then their agents an incentive to offer settlement of trades competitively. This can be achieved by splitting the profits from settlement between the firm and the agent. Since competition between the two agents reveals the true costs, the two firms can then merge their trading operations and settle all trades with the agent that offers the lowest price for settlement. This corresponds to the efficient solution where the trading of the two firms is merged, while all trades get settled at the lowest cost.

The recent experience of consolidation among European stock exchanges supports our findings. The case of Euronext, a merger between the Paris, Bruxelles and Amsterdam stock exchanges, was accompanied with the vertical disintegration of these exchanges which were originally set up as vertical structures. A similar project, the iX trading platform between

London Stock Exchange and the Deutsche Börse in Frankfurt, failed however. Interestingly, Deutsche Börse pursued the creation of a vertical silo in parallel to the planned merger. In a case study, we describe these recent experiences in more detail and provide evidence that vertical structures such as Deutsche Börse formed an impediment to efficient market consolidation in the Euro-area.

# 1 Introduction

Clearing and settlement systems have as of lately received a lot of attention in the context of financial integration of the euro area. The Giovannini Reports (2001) and (2003) discovered sizeable transaction costs and risks in the current clearing and settlement infrastructure that prevent efficient cross-border trading within Europe. It is therefore argued that the consolidation of this infrastructure is the key element for realizing large efficiency gains inherent in financial markets integration.<sup>1</sup>

We demonstrate in this paper, however, that such a consolidation does not necessarily lead to an *efficient* financial market organization. In particular, we find that it is impossible to reap the full gains of horizontal consolidation if trading, clearing and settlement take place in vertically integrated firms and costs for clearing and settlement are private information. Furthermore, we show that breaking up these vertical silos and inducing competition in the areas of clearing and settlement can realize all efficiency gains from consolidation.

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Using methods from mechanism design we show that there is no mechanism that allows the players to merge the vertically integrated firms in a way that trading and settlement are produced efficiently after the merger. Interestingly, this is independent of the overall gains in revenue that are obtained from increasing overall demand for the merged firms. It is

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<sup>1</sup>See also Green (2001) who assesses the importance of clearing and settlement structures for the development of financial markets.



important to emphasize that this result is not about the possibility of a merger per se, but about achieving an efficient merger, i.e. a merger that realizes *all* possible benefits associated with the merger.

The reason for this result is as follows. A merger has to specify how the overall joint revenue is shared between the players and which of the two firms provides the settlement of trades after the merger. For the merger to be efficient, the players have to ensure that the lowest cost firm will carry out settlement. Since the costs for settlement are private information, truthful revelation of the costs implies that the share of revenue a player obtains varies with the costs announced by a player. However the total post-merger revenue net of production cost is constant. Therefore, it is infeasible to give proper incentive to two players simultaneously, since what is granted to one cannot be granted to the other and vice versa.

We offer two ways to overcome the problems inherent in the vertically integrated structure. First, if a subsidy is available to vary the overall gains from merging, the incentives to reveal the costs can be restored. Provided the gains arising from additional demand are large, the required subsidy can even be negative which is equivalent to taxing the merger.

The second way is a market solution and is based on vertical disintegration. Here each player delegates the operation of his settlement platform to an agent which we assume to be an insider, i.e., we assume that the agent can observe the true cost of settlement. The players give then their agents an incentive to offer settlement of trades competitively. This can be achieved by splitting the profits from settlement between the firm and the agent. Since competition between the two agents reveals the true costs, the two firms can then merge their trading operations and settle all trades with the agent that offers the lowest price for settlement. This corresponds to the efficient solution where the trading of the two firms is merged, while all trades get settled at the lowest cost.

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Deutsche Börse pursued the creation of a vertical silo in parallel to the planned merger. Below we describe these recent experiences in more detail and provide evidence that vertical structures such as Deutsche Börse formed an impediment to efficient market consolidation.

The remainder of the paper is organized as follows. We start our analysis in Section 2 with a detailed case study of the Euronext and the planned iX merger. Section 3 outlines our model. We derive the impossibility result of achieving an ex-post efficient merger in Section 4. We then describe how a subsidy (or a tax) can restore efficiency. Section 5 demonstrates that vertical delegation can solve the problem of implementing mergers efficiently. The last section concludes.

## **2 Securities Settlement Systems and the Consolidation of Securities Markets**

### **2.1 Securities Market Organization - A Brief Overview**

Transacting securities involves other actions than simply trading, i.e., buying and selling a security. For clarity and to demonstrate their importance, we briefly review the so-called back office services that are necessary to effect a trade in securities market.

There are two different operations that complete a trade of a security. The first one, clearing the trade, confirms the legal obligations from the trade. Clearing involves (among possible other services) transmitting and reconciling the terms of a securities' trade between the buyer and seller. In some cases this is taken on by a special entity, a clearing house, that can also function as what is called a Central Counterparty or CCP. This entity interposes itself as the buyer to every seller and the seller to every buyer of a security.

Following the clearing stage the second operation is settling a trade. This involves the actual transfer of ownership from the seller to the buyer as well as the payment for the security by the buyer thereby discharging the legal obligations from the trade. This operation is often handled by a so-called Central Security Depository (or CSD) that holds the security and

transfers the title of the security from the seller to the buyer after the transaction has been cleared.

Stock exchanges and other trading platforms often operate in vertical silos offering a one-stop service to traders. This service ranges from executing a trade over clearing the transaction to settling it by transferring the title of the security and the payment between the parties of the trade. In these vertical silos, the stock exchange either directly owns or controls the clearing house and/or the CSD that are responsible for clearing and settling the trades.

## 2.2 Securities Market Consolidation in Europe - A Case Study

The introduction of a single currency for the euro area from 1998 onwards prompted a process of consolidation within the infrastructure of European securities markets. We give here a brief overview over this process. Our goal is to demonstrate that questions regarding the ownership and structure of clearing and settlement arrangements decisively shaped this process.

There are two recent examples from the European experience that indicate why some consolidation was successful, while other developments are still unresolved. The first one is the successful merger between the Amsterdam, Bruxelles and Paris stock exchanges labelled Euronext. The second one is the failed creation of iX, a merger of Deutsche Börse (DB) and the London Stock Exchange (LSE). In both cases it is striking that settlement arrangements played seemingly an important - if not decisive - role for the outcome of the merger.

As early as 1998, the LSE and DB expressed their intention to form a joint trading platform called iX to consolidate the nationally orientated exchanges. Spurred by the promise of huge cost savings<sup>2</sup> the move gathered momentum quickly with six other European exchanges (Amsterdam, Bruxelles, Madrid, Milan, Paris, Swiss) joining the plan until May, 1999. During the merger talks between the exchanges, a parallel process was initiated in the area of back office operations. CEDEL, an internationally operating settlement agent merged with DB Clearing in July 1999 to form Clearstream. Shortly after, DB bought a controlling stake

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<sup>2</sup>The LSE for example estimates the total cost savings from consolidation of clearing and settlement in Europe to be around 1.6bn Euro per year (LSE (2002)).

(50%) in Clearstream to set up a vertically integrated exchange in Germany.

This move coincides with a reorientation of some other stock exchanges. First, Euronext was launched in March 2000, when Sicovam, the CSD of the Paris stock exchange, broke off merger talks with Clearstream. Shortly afterwards, the iX merger failed seemingly over problems with finding the right arrangement on the settlement layer. The Financial Times reported in their July, 20th 2000 edition that

“Clearstream and Crest [the settlement agent for London’s securities markets] would make an announcement at the end of August on what clearing and settlement service they intended to offer to users of ... iX. Shareholders of the two exchanges are already agitating for answers to that essential question. It seems likely that the solution to be offered will be interim. Such a step would be unlikely to offer the cost savings that iX is promising...”

While the iX merger failed, the Euronext merger was completed by September 2000. The key step was to consolidate clearing and settlement in an independent entity. This was achieved through incorporating the French, Dutch and Belgian CSDs into Euroclear, the second major international settlement agent. Euronext has expanded recently to include the Lisbon exchange as well as the LIFFE, a London based future and derivatives exchange. Both these acquisitions were accompanied by the merger of the settlement agents, Interbolsa and Crest, with Euroclear. Finally, in June 2003, the clearing arrangements for Euronext were consolidated by merging Clearnet, the former French CPP, with its London counterpart, the London Clearing House (LCH).

Looking back at this experience one is struck by the evidence that the success for consolidation rested upon finding a solution for merging not only trading, but also settlement and clearing arrangements.<sup>3</sup> DB’s strategy of erecting a vertical silo seemed to be the main reason that

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<sup>3</sup>As the Financial Times noted on July, 14th 2000, “...[The] integration of Euronext for trading, settlement and clearing will probably be faster and easier to achieve than for the proposed iX merger...[which] still has to decide whether ... it will rely on Crest ... or Clearstream to settle equities. ... experts question whether this is feasible in practice.” On October 25th, 1999 it was stated that “At the heart of the problem has been disagreement between London and Frankfurt over which electronic trading platform and which clearing and settlement system to choose.”



prevented a potential merger to realize efficiency gains between LSE and DB. This is backed best by a recent statement issued by the LSE (LSE (2002)).

“...[The] optimal solution is to create a single system ... that is run as a ‘utility’ and is independent of exchanges and other trading platforms. (p.8) ... Action is required to impose the separation of trading platforms and clearing and settlement activities. Vertical silos, especially if run as for-profit businesses, have perverse incentives ... to prevent interoperability and further consolidation at the clearing and settlement level. Breaking up these silos and separating trading platforms from clearing and settlement systems is a vital preliminary step towards establishing an efficient market structure. (p.21)”

Why was the Euronext merger then successful? The answer seems again to be buried in the back office structures. Euroclear was an independent entity from the start. After the acquisition of Clearstream by DB, it was the natural catalyst for moving from vertical to horizontal integration for the Euronext project. The vertical silo structure of DB to the contrary was a clear disadvantage in leading a consolidation process. As Pierre Francotte, CEO of Euroclear, expressed it when defending the company’s approach,

“Euroclear believes that horizontal integration, with users rather than stock exchanges owning and governing the settlement service providers, is the best way of achieving the market’s objectives of lower transaction costs and higher efficiency. However, until such time that a pan-European settlement solution is in place, it is essential for users to have a choice of settlement location for their trade. ... The vertical silo approach - where stock exchanges own and govern their clearing and settlement houses - makes settlement location more difficult to achieve. Which stock exchange or CCP will want to feed business and revenues to a settlement house that is owned and controlled by one of its competitors?” (The Banker, June 1st, 2002)

Looking back at this evidence, we feel that three main factors are important for understanding it. First, major gains from horizontal consolidation of security markets arise in form of cost savings in the area of back office operations. Second, ownership of settlement and clearing operations by exchanges can be an impediment to realize these gains. Third, breaking up vertically integrated exchanges can be a way to capture the gains from horizontal consolidation.

### 3 Environment

We confirm our assessment now by analyzing a simple model that investigates whether vertically integrated firms can capture all gains from horizontal consolidation. We consider an economy with two firms,  $i = 1, 2$ , owned by player  $i$ . Each firm produces a service, which encompasses production of a final product (here carrying out a trade on a stock exchange) and distributing the product (here clearing and settling a trade). The cost for a firm of running the trading platform is normalized to 0 while the cost of running the settlement platform is  $\theta_i$ , distributed according to a common density function  $f$  with support  $[0, 1]$ . We assume that  $\theta_i$  is private information of player  $i$ .

Each firm is assumed to be initially vertically integrated. If a trade takes place on platform  $i$ , it has to be settled on platform  $i$ . For simplicity, we assume that each firm faces a demand  $D_i$  taking the following form:  $D_i = 1$  if  $p_i \leq \bar{p}$  and zero otherwise. Hence, there is no substitution between the products of the two firms and the demand is inelastic up to price  $\bar{p}$ . The profit of player  $i$  from operating the firm is  $\tilde{\Pi}_i(\theta_i) = \bar{p} - \theta_i$ . Note that the price does not reveal the cost of settlement. Hence, player  $j$  cannot observe the cost  $\theta_i$  from the price firm  $j$  quotes for trading plus settlement. We assume that  $\bar{p} > 1$ .<sup>4</sup>

If the two firms merge, they can realize an additional demand equal to  $d \geq 0$ . Total demand for the merged firms is then given by  $2 + d$  if  $p \leq \bar{p}$  and 0 otherwise. Hence, there are two potential gains from merging. First, the players could merge the firms and realize the extra

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<sup>4</sup>This assumption can be interpreted as the firms operating in segmented markets offering a single, indivisible good. We discuss this assumption in more detail in the last section of the paper.

demand if  $d > 0$ . Second, if  $\theta_1$  and  $\theta_2$  are different the merged firm could offer settlement for all the demand at lower cost. Thus, if the costs were common knowledge, then firm 1 and 2 would merge, satisfy the joint demand of  $2 + d$  at a price  $p = \bar{p}$ , produce settlement at  $\min\{\theta_i, \theta_j\}$  and realize in all cases a joint profit that is larger than the sum of individual profits. Costs  $\theta_i$  are private information, however, and can not be discovered by merging the two firms. This means that the costs do not become common knowledge for the players after a merger between the firms is completed.<sup>5</sup>

## 4 Impossibility of Ex-Post Efficient Mergers

The benefits from merging can only be exploited if settlement costs are known. In this section we show that private information on the costs of settlement renders an efficient merger impossible independent of  $d$ . For an efficient merger the additional benefits arise in part from the use of the most efficient settlement system. These benefits have to be shared among the two firms with the size of the benefits depending on the difference of settlement costs between the two firms. With  $\theta_i$  being private information, how these profits are shared can, however, only depend on the costs the firms announce. Hence, a firm can influence its share of the profit through its announcement of costs. Unless the sharing rule can elicit truthful revelation of costs, an efficient merger is then not possible.

Using ideas from mechanism design we ask whether there exists a mechanism that can implement the use of the most efficient settlement platform after the merger between the firms has taken place. Invoking the revelation principle, we restrict ourselves to studying direct mechanisms where firms only make a cost announcement. A direct mechanism is a function  $M = (t, y)$  that specifies for each announcement  $\theta = (\theta_1, \theta_2)$  a transfer rule  $t(\theta) = (t_1(\theta), t_2(\theta))$  and an allocation rule  $y(\theta) = (y_1(\theta), y_2(\theta))$  of settlement operations. Given  $\theta$ , the payoff for each player is then given by  $\Pi_i(t, y|\theta) = t_i(\theta) - (2 + d)y_i(\theta)\theta_i$ . We define further that a mechanism is *Bayesian incentive-compatible* if for each  $i, j$  such that  $\theta_i$  is the true type of  $i$

<sup>5</sup>The often intricate nature of settlement and clearing procedures make it difficult to identify the true costs of any particular arrangement (see for example Giovannini (2001) and (2003)).

and  $\theta_j$  is the true type of  $j$ ,

$$\int t_i(\theta_i, \theta_j) - (2+d)y_i(\theta_i, \theta_j)\theta_i dF(\theta_j) \geq \int t_i(\theta'_i, \theta_j) - (2+d)y_i(\theta'_i, \theta_j)\theta_i dF(\theta_j) \quad \text{for all } \theta'_i. \quad (4.1)$$

Next, a mechanism is *feasible* if, first, it is individually rational, i.e., the expected profit for each player from merging is at least as high as the profit from not merging,

$$\int \Pi_i(t, y|\theta_i, \theta_j) f(\theta_j) d\theta_j \geq \tilde{\Pi}_i(\theta_i), \quad (4.2)$$

second, the whole return from the merged firms are distributed between the players

$$t_1(\theta) + t_2(\theta) = (2+d)\bar{p}, \quad (4.3)$$

third, transfers are feasible, i.e., positive,

$$t_i(\theta) \geq 0 \text{ for all } \theta, \quad (4.4)$$

since we assume that the players do not have initial wealth<sup>6</sup> and

$$\sum_{i=1}^2 y_i(\theta) = 1 \text{ for all } \theta, \quad (4.5)$$

where  $y_i(\theta) \geq 0$  for all  $i$ .

Finally, an allocation is *ex-post efficient* if the settlement platform with the lowest cost carries out settlement, i.e.,

$$y_i(\theta) = 1 \text{ if } \theta_i \leq \theta_j \text{ and } 0 \text{ otherwise.} \quad (4.6)$$

In the sequel we will abuse language slightly by using ‘ex-post efficient merger’ instead of ‘ex-post efficient allocation’ of settlement activities. We then have the following impossibility result which is an application of a result due to Myerson and Satterthwaite (1983).

**Theorem 1.** *There is no incentive-compatible and feasible mechanism that implements an ex-post efficient merger between the two firms.*

<sup>6</sup>Note, however, from the definition of  $\Pi_i$  that the players’ payoffs can be negative.



*Proof.* Suppose that there exists an incentive compatible and feasible mechanism  $(t, y)$ , where  $y$  is ex-post efficient. Define the expected payoff of type  $\theta_i$  from taking part in the mechanism given type  $j$  reveals his type truthfully as  $\bar{\Pi}_i(t, y|\theta_i) = \int \Pi_i(t, y|\theta_i, \theta_j) f(\theta_j) d\theta_j$ . Also define the expected probability to produce of a type  $\theta_i$  given  $j$  reveals his type truthfully as  $\bar{y}_i(\theta_i) = \int y_i(\theta_i, \theta_j) f(\theta_j) d\theta_j$ . Similarly, define the expected transfer to a type  $\theta_i$  as  $\bar{t}_i(\theta_i) = \int t_i(\theta_i, \theta_j) f(\theta_j) d\theta_j$ . From the incentive compatibility constraint (4.1) we have for all  $\theta_i$  and  $\theta'_i$

$$\begin{aligned}\bar{\Pi}_i(t, y|\theta_i) &= \bar{t}_i(\theta_i) - (2 + d)\bar{y}_i(\theta_i)\theta_i \geq \bar{t}_i(\theta'_i) - (2 + d)\bar{y}_i(\theta'_i)\theta_i \\ \bar{\Pi}_i(t, y|\theta'_i) &= \bar{t}_i(\theta'_i) - (2 + d)\bar{y}_i(\theta'_i)\theta'_i \geq \bar{t}_i(\theta_i) - (2 + d)\bar{y}_i(\theta_i)\theta'_i.\end{aligned}$$

Therefore,

$$(2 + d)\bar{y}_i(\theta_i)(\theta'_i - \theta_i) \geq \bar{\Pi}_i(t, y|\theta_i) - \bar{\Pi}_i(t, y|\theta'_i) \geq (2 + d)\bar{y}_i(\theta'_i)(\theta'_i - \theta_i)$$

which shows that  $\bar{y}_i(\theta_i)$  is non-increasing. Setting  $\theta'_i = \theta_i + \varepsilon$  and letting  $\varepsilon$  converge to zero, we obtain

$$\frac{\partial \bar{\Pi}_i(t, y|\theta_i)}{\partial \theta_i} = -(2 + d)\bar{y}_i(\theta_i).$$

Hence we have that  $\bar{\Pi}_i(t, y|\theta_i) = \bar{\Pi}_i(t, y|s_i) - \int_{s_i}^{\theta_i} (2 + d)\bar{y}_i(v_i) dv_i$ .

From the definition of expected transfer we obtain

$$\begin{aligned}\int_0^1 \bar{t}_i(\theta_i) f(\theta_i) d\theta_i &= \int_0^1 \left( \bar{\Pi}_i(t, y|\theta_i) + (2 + d)\bar{y}_i(\theta_i)\theta_i \right) f(\theta_i) d\theta_i \\ &= \int_0^1 \left( \bar{\Pi}_i(t, y|s_i) - (2 + d) \left[ \int_{s_i}^{\theta_i} \bar{y}_i(v_i) dv_i \right] + (2 + d)\bar{y}_i(\theta_i)\theta_i \right) f(\theta_i) d\theta_i \\ &= \bar{\Pi}_i(t, y|s_i) + (2 + d) \int_0^1 \left( \bar{y}_i(\theta_i)\theta_i - \int_{s_i}^{\theta_i} \bar{y}_i(v_i) dv_i \right) f(\theta_i) d\theta_i \\ &= \bar{\Pi}_i(t, y|s_i) + (2 + d) \int_0^1 \bar{y}_i(\theta_i) \Psi(\theta_i, s_i) f(\theta_i) d\theta_i\end{aligned}$$

where  $\Psi(\theta_i, s_i) = \theta_i - \frac{1-F(\theta_i)}{f(\theta_i)}$  if  $s_i < \theta_i$  and  $\theta_i + \frac{F(\theta_i)}{f(\theta_i)}$  if  $s_i > \theta_i$ .

Using ex-post efficiency, this implies that the expected payoff for a given type  $s_i$  is given by

$$\begin{aligned}
& \bar{\Pi}_i(t, y|s_i) = \\
&= \int_0^1 \bar{t}_i(\theta_i) f(\theta_i) d\theta_i - (2+d) \int_0^1 \bar{y}_i(\theta_i) \Psi(\theta_i, s_i) f(\theta_i) d\theta_i \\
&= \int_0^1 \bar{t}_i(\theta_i) f(\theta_i) d\theta_i - (2+d) \left[ \int_0^1 \bar{y}_i(\theta_i) \theta_i f(\theta_i) d\theta_i + \int_0^{s_i} \bar{y}_i(\theta_i) F(\theta_i) d\theta_i - \int_{s_i}^1 (1-F(\theta_i)) \bar{y}_i(\theta_i) d\theta_i \right] \\
&= \int_0^1 \bar{t}_i(\theta_i) f(\theta_i) d\theta_i - (2+d) \left[ \int_0^1 \bar{y}_i(\theta_i) \theta_i f(\theta_i) d\theta_i + \int_0^1 (1-F(\theta_i)) F(\theta_i) d\theta_i - \int_{s_i}^1 (1-F(\theta_i)) d\theta_i \right] \\
&= \int_0^1 \bar{t}_i(\theta_i) f(\theta_i) d\theta_i + (2+d) \left[ \int_0^1 \bar{y}_i(\theta_i) \theta_i f(\theta_i) d\theta_i - [E(\theta_i|\theta_i \leq s_i) + s_i(1-F(s_i))] \right].
\end{aligned}$$

Hence, the expected payoff of type  $s_i$  is equal to the average pay-off for player  $i$  plus the surplus his information creates.

Now, let  $s_i = 0$  for all  $i$ . That is we consider the type of firms that have the least benefit from merging as they are the most efficient. Total transfers are then given by

$$\begin{aligned}
\int t_1(\theta) + t_2(\theta) f(\theta) d\theta &= \int \bar{t}_1(\theta_1) f(\theta_1) d\theta_1 + \int \bar{t}_2(\theta_2) f(\theta_2) d\theta_2 \\
&= \bar{\Pi}_1(t, y|0) + \bar{\Pi}_2(t, y|0) - 2(2+d) \left[ \int_0^1 \bar{y}_i(\theta_i) \theta_i f(\theta_i) d\theta_i \right].
\end{aligned}$$

From feasibility we have  $t_1(\theta) + t_2(\theta) = (2+d)\bar{p}$  for all  $\theta$  so that

$$\int t_1(\theta) + t_2(\theta) f(\theta) d\theta = (2+d)\bar{p}.$$

This implies that

$$\bar{\Pi}_1(t, y|0) + \bar{\Pi}_2(t, y|0) - 2(2+d) \left[ \int_0^1 \bar{y}_i(\theta_i) \theta_i f(\theta_i) d\theta_i \right] = (2+d)\bar{p}.$$

Since both firms have zero cost, the expected profit from an ex-post efficient merger to be shared is the full return  $(2+d)\bar{p}$ . Therefore, when both firms have zero cost it must be that  $\bar{\Pi}_1(t, y|0) + \bar{\Pi}_2(t, y|0) = (2+d)\bar{p}$ . This gives a contradiction since  $\bar{\Pi}_1(t, y|0) + \bar{\Pi}_2(t, y|0) = (2+d)\bar{p} + 2(2+d) \left[ \int_0^1 \bar{y}_i(\theta_i) \theta_i f(\theta_i) d\theta_i \right] > (2+d)\bar{p}$ .  $\square$

This result shows that an ex-post efficient merger can not be implemented between the two firms because the incentives of misrepresenting their own costs are too strong. The intuition of the result is simple. A feasible mechanism that implements an ex-post efficient merger must specify a transfer that will redistribute the *overall* profit from production while ensuring that the lowest cost producer will carry out production. Eliciting truth-telling is however costly. For instance, a low cost firm, has an incentive to announce higher than its true costs. In doing so, it is still likely to produce and, by pretending that costs are higher, it causes total profits from the cost savings to appear lower than they are. This difference between apparent profits and true profits fully accrues to the producing firm. Hence misrepresenting costs affects the transfers, but also the remaining profit that a firm can keep for itself.

Our assumption on limited liability implies that truth-telling can only be elicited using the revenue from the merger  $(2 + d)\bar{p}$ . This is independent of costs. Hence, what is promised to one firm to elicit truthful revelation is not available to set up the incentives of the other firm right. As a consequence, for certain combinations of costs, the total revenue from the merger may not be enough to elicit truth-telling for both firms. In other words, as the mechanism has to distribute *all* the revenue between the two firms, it is impossible to design transfers that distribute all the revenue while giving both firms appropriate incentives to truthfully reveal their costs.

An interesting property is that the impossibility result does not depend on the magnitude of the additional demand  $d$ . The reason is that  $d$  is known by both firms and is not affected by the true costs of the producing firm. Since the total revenue from merging including the additional revenue  $\bar{p}d$  must be split between the two firms, transfers always have to include all revenue. As firms are risk neutral, the severity of the incentive problem is unaffected by the magnitude of  $d$ . Hence, the costs of eliciting the truth is independent of  $d$ . Therefore, the efficient merger is as difficult to implement when  $d > 0$  as when  $d = 0$ .

From the proof of Theorem 1, we can infer, however, that a subsidy can implement a merger ex-post efficiently. Since a subsidy can depend on the firms' announcements, the revenue from the merger plus the subsidy can vary with the announced costs. Whenever the subsidy is decreasing with the cost one can counteract the incentive to report a high cost in order to

get a higher payoff. Hence, by changing the total revenue that can be shared between the firms, a subsidy will enable the firms to overcome the informational problem. This is what we show in the next result, where we assume for simplicity that  $f$  is the uniform distribution on  $[0, 1]$ .

**Theorem 2.** *There exists a subsidy schedule  $s_i(\theta)$  for all  $\theta$  and all  $i$ , such that an ex-post efficient merger is implementable. Furthermore, there exists  $d^*(\bar{p}) > 0$  such that, for  $d > d^*(\bar{p})$ , an ex-post efficient merger can be implemented with  $s_i(\theta) \leq 0$  for all  $\theta$  and all  $i$ . Finally,  $d^*(\bar{p}) \rightarrow \infty$  as  $\bar{p} \rightarrow 1$ .*

*Proof.* We now set the transfers to be  $t_i(\theta) = \tau_i(\theta) + s_i(\theta)$ , where  $\tau_i(\cdot)$  is the sharing rule of the return from the merger and  $s_i(\cdot)$  is the subsidy received. Hence,  $\bar{\tau}_i(\theta_i) + \bar{\tau}_j(\theta_j) = (2 + d)\bar{p}$  for all  $\theta_i$  and  $\theta_j$ . Using a standard result of implementation theory (see for example Proposition 23.D.2 in Mas-Colell, Whinston and Green (1995)) an ex-post efficient merger is implementable if and only if, for all  $i$

- the function  $(2 + d)\bar{y}_i(\theta_i)$  is non-increasing,
- $\bar{\Pi}_i(t, y|\theta_i) = \bar{\Pi}_i(t, y|0) - \int_0^{\theta_i} (2 + d)\bar{y}_i(v_i)dv_i$  for all  $\theta_i \in [0, 1]$  and
- $\bar{\Pi}_i(t, y|\theta_i) \geq \bar{p} - \theta_i$ .

where  $y_i(\theta)$  is ex post efficient. Since  $y_i(\theta)$  is ex post efficient, the first condition is clearly fulfilled.

We will now derive conditions on  $t_i(\cdot)$  such that the last two conditions hold. The second condition implies for  $y_i(\theta)$  being ex-post efficient that  $\bar{\Pi}_i(t, y|\theta_i) - \bar{\Pi}_i(t, y|0) = -(2 + d)(\theta_i - \theta_i^2/2)$ . Furthermore, by definition of the average pay-off for type  $\theta_i$  we have  $\bar{\Pi}_i(t, y|\theta_i) = \bar{t}_i(\theta_i) - \theta_i(2 + d)(1 - \theta_i)$  for all  $\theta$ . Thus the second condition is equivalent to

$$\bar{t}_i(\theta_i) = \bar{t}_i(0) - (2 + d)\frac{\theta_i^2}{2}.$$

Hence,

$$\begin{aligned} \bar{t}_i(\theta_i) + \bar{t}_j(\theta_j) &= \bar{t}_i(0) + \bar{t}_j(0) - \frac{\theta_i^2 + \theta_j^2}{2}(2 + d) \\ &= \bar{s}_i(0) + \bar{s}_j(0) + (2 + d) \left[ \bar{p} - \frac{\theta_i^2 + \theta_j^2}{2} \right]. \end{aligned}$$

Since, by definition,  $\bar{t}_i(\theta_i) + \bar{t}_j(\theta_j) = (2 + d)\bar{p} + \bar{s}_i(\theta_i) + \bar{s}_j(\theta_j)$ , we obtain

$$\bar{s}_i(\theta_i) + \bar{s}_j(\theta_j) = \bar{s}_i(0) + \bar{s}_j(0) - \frac{\theta_i^2 + \theta_j^2}{2}(2 + d),$$

where  $\bar{s}_i(\theta_i)$  is the expected subsidy received by type  $\theta_i$ . Using symmetry, we can then set the subsidy equal to

$$\bar{s}_i(\theta_i) = \bar{s}_i(0) - \frac{\theta_i^2}{2}(2 + d)$$

and the sharing rule equal to

$$\bar{\tau}_i(\theta_i) = \frac{(2 + d)\bar{p}}{2}.$$

For the third condition to be fulfilled, we need  $\bar{s}_i(0)$  to be large enough for all  $i$ . Indeed, using the expressions for  $\bar{s}_i(\theta_i)$  and  $\bar{\tau}_i(\theta_i)$ , the individual rationality constraint of firm  $i$  can be rewritten as

$$\bar{\tau}_i(0) + \bar{s}_i(0) \geq \bar{p} + (1 + d)\theta_i - (2 + d)\frac{\theta_i^2}{2}$$

where the right hand side is maximized at  $\theta^* = (1 + d)/(2 + d)$ . Since  $\bar{\tau}_i(0) = (2 + d)\bar{p}/2$ , we get

$$\bar{s}_i(0) \geq \frac{(1 + d)^2}{2(2 + d)} - \frac{d}{2}\bar{p}. \quad (4.7)$$

Hence, an ex-post efficient merger is implementable with a schedule of transfers  $\{t_1(\theta), t_2(\theta)\}$  such that  $\bar{t}_i(\theta_i) = \bar{\tau}_i(\theta) + \bar{s}_i(\theta)$  where  $\bar{\tau}_i(\theta_i)$  and  $\bar{s}_i(\theta_i)$  satisfy the expressions given above. This proves the first part of Theorem 2. To prove the second part, notice that so far we imposed no restriction on the sign of  $\bar{s}_i(\theta_i)$ . Hence, we obtain the result by setting  $\bar{s}_i(0) \leq 0$  and using the expression above to define  $\bar{s}_i(\theta_i)$ . Since  $\bar{s}_i(0) \geq \frac{(1+d)^2}{2(2+d)} - \frac{d}{2}\bar{p}$ , we must have  $\frac{(1+d)^2}{2(2+d)} - \frac{d}{2}\bar{p} \leq 0$ , where the left hand side is decreasing in  $d$ . The remainder of the result then follows.  $\square$

This proof clarifies further the impossibility result by fully characterizing the symmetric subsidy needed for establishing ex-post efficiency. To balance the incentives of obtaining a higher share of revenue by claiming higher costs, one has to decrease payoffs net of settlement costs just fast enough with the announced costs. This is best demonstrated when looking at a negative subsidy or a tax.

Taxing the revenues after the merger reduces the total revenue available for the two players. By decreasing the pay-offs net of costs appropriately with the announced costs, players do

not have an incentive to lie anymore. This was not possible when revenues were constant at  $(2 + d)\bar{p}$ . There, decreasing the share for one player means increasing the share of the other player. Hence, it is impossible to design the incentive structure simultaneously for both players if all revenues have to be shared. In other words, with a tax (or subsidy) one can separate the effects of an announcement of one player on the other and vice versa.

Of course, when taxing the players one might violate individual rationality. Given  $\bar{p}$ , this is the case when the gains in revenue from the merger as expressed by  $d$  are sufficiently low. Whenever this is the case, however, a subsidy can still achieve ex-post efficiency, because one can just make participation more attractive by adding a constant lump sum transfer without affecting incentives.

## 5 Enabling an Ex-post Efficient Merger: A Market Solution

In this section, we explore a second way to implement an ex-post efficient merger. The key idea is here to rely on a market solution where prices fully reveal costs. Each player can delegate settlement activities to an insider who knows the costs and competes for carrying out settlement of all post-merger trades. If these agents have an incentive to reveal the costs when competing for the market, efficient settlement will occur.

### 5.1 A Bertrand game between settlement platforms

We first study whether agents that compete for the market choose a pricing strategy that fully reveals costs of settlement. Let  $p_i$  be the price set by agent  $i$  running settlement platform  $i$ . For later reference, we assume that agent  $i$  can retain a share  $\alpha_i \in (0, 1]$  of profits. Since the platform with the lowest price will get all the demand for settlement, the payoff of agent

$i$  is then given by

$$u_i(p_i, p_j) = \alpha_i(2 + d) \begin{cases} (p_i - \theta_i) & \text{if } p_i < p_j \\ (p_i - \theta_i)/2 & \text{if } p_i = p_j \\ 0 & \text{if } p_i > p_j. \end{cases} \quad (5.1)$$

We consider the Bayesian Nash equilibria of a game where both agents simultaneously announce a price  $p_i$ : For all  $\theta_i$ , agent  $i$  has to choose a price  $p_i(\theta_i)$  that is a best response to the price schedule  $p_j(\cdot)$  of agent  $j$  given the distribution of  $\theta_j$  which we choose to be uniform for this section. Hence, agent  $i$  chooses  $p_i(\theta_i)$  to solve

$$\begin{aligned} p_i(\theta_i) &= \arg \max_{p_i} \int_{\{\theta_j: p_j(\theta_j) > p_i\}} (p_i - \theta_i) d\theta_j + \int_{\{\theta_j: p_j(\theta_j) = p_i\}} \frac{1}{2} (p_i - \theta_i) d\theta_j \\ &= \arg \max_{p_i} (p_i - \theta_i) P(p_j(\theta_j) > p_i) + \frac{1}{2} (p_i - \theta_i) P(p_j(\theta_j) = p_i), \end{aligned} \quad (5.2)$$

where  $P(\mathcal{A})$  denotes the probability of event  $\mathcal{A}$ . We show next that the price schedule in equilibrium is strictly increasing and, hence, reveals the settlement costs.

**Proposition 1.** *The equilibrium pricing strategy  $p_i(\theta_i)$  is continuous and strictly increasing on  $[0, 1]$  for all  $i$ .*

*Proof.* See Appendix. □

Even though this result is sufficient to establish that the market solution reveals the costs, we derive a closed form solution for the equilibrium pricing strategies. This will simplify the exposition further. As  $p_i(\cdot)$  is strictly increasing, we can define  $\phi(p) = p_i^{-1}(p) = \theta_i$  as the inverse function of  $p_i(\cdot)$ . Since it is monotonic,  $\phi(\cdot)$  is differentiable almost everywhere. Setting a price  $p_i$ , agent  $i$  supplies the whole market if  $p_j(\theta_j) > p$ , i.e., if  $\theta_j > \phi_j(p)$ . This occurs with probability  $1 - F(\phi_j(p))$ , where  $F$  is the distribution of  $\theta_j$ . Hence, we can rewrite agent  $i$ 's problem (5.2) as follows

$$\max_p (p - \theta_i)[1 - F(\phi_j(p))]. \quad (5.3)$$

Using the fact that  $\theta_i = \phi_i(p)$ , that  $F(\cdot)$  is uniform and the first order condition for the above problem, we obtain

$$\phi_j(p) = 1 + (\phi_i(p) - p)\phi_j'(p). \quad (5.4)$$

**Lemma 1.** *The equilibrium strategies are symmetric, i.e.,  $\phi_i(p) = \phi_j(p) \equiv \phi(p)$  for all  $p$  and  $\phi(1) = 1$ .*

*Proof.* See Appendix. □

Given symmetry, equation (5.4) can be written as  $\phi(p) = 1 + (\phi(p) - p)\phi'(p)$  and since  $\phi(1) = 1$  we obtain that the unique solution to this differential equation is  $\phi(p) = 2p - 1$ . Hence, the best response function for all agents satisfies  $p_i(\theta_i) = (\theta_i + 1)/2$ .

## 5.2 Implementing the market solution

We investigate whether it is optimal for the players to separate trading from settlement in order to fully realize the gains from merging. A market mechanism specifies an action set  $A_i$  for each player  $i$  and a market outcome function. The market outcome function describes whether a merger takes place and whether the players separate trading and settlement. Furthermore, it specifies transfers to the players, the allocation of production in terms of the prices quoted by the agents and the profit share the agents obtain. Hence, we denote the outcome function by a quadruple  $(m, t, y, \alpha)(a, p)$ , that expresses all these variables as functions of the players' actions  $a = (a_1, a_2) \in A_1 \times A_2$  and the prices  $p = (p_1, p_2) \in \mathbb{R}_+^2$  resulting from the Bertrand Game between the agents.

The function  $m(a, p) \in \{0, 1\}$  describes then whether players delegated the operation of the settlement platform to agents and whether a merger takes place. We let  $m(a, p) = 1$  express the fact that a merger takes place and agents are hired to operate the settlement platforms.

A market outcome is *feasible* for  $m = 0$  if, for all  $a \in A$  such that  $m = 0$ ,  $t_i(a, p) = \bar{p}$ ,  $\alpha_i(a, p) = 0$  and  $y_i(a, p) = 1$  for all  $i$ . Hence, if a merger does not take place, each firm settles its own trades and transfers are given by the revenue from trading.

Note that after the merger and after splitting off the settlement platforms, total profits (and, hence, transfers) consist of the revenue from trading,  $(2 + d)\bar{p}$  and the profits from the settlement operations minus the costs from paying for settlement  $p_i$  and the fees paid to the



agents. A market outcome is *feasible for  $m = 1$*  if, for all  $a \in A$  such that  $m = 1$ , transfer schedules are restricted by limited wealth, i.e.,

$$t_i(a, p) \geq 0 \quad (5.5)$$

for all  $i$ ,

$$\sum_{i=1}^2 y_i(a, p) = 1 \quad (5.6)$$

and transfer schedules distribute all revenues from the merger between the players,

$$t_1(a, p) + t_2(a, p) = (2 + d)\left[\bar{p} - \sum_{i=1}^2 y_i(a, p)p_i + \sum_{i=1}^2 (1 - \alpha_i(a, p))y_i(a, p)(p_i - \theta_i)\right]. \quad (5.7)$$

Finally, we say that a market outcome is *feasible* if it is feasible for  $m = 0$  and  $m = 1$ . We then have the following definition.

**Definition 1.** *A market outcome  $(m, t, y, \alpha)$  is strongly implementable if it is feasible and the unique perfect Bayesian Nash equilibrium of a market mechanism.*

Note that this definition requires that the market outcome is the equilibrium outcome for all strategies of the players that form a Bayesian Nash equilibrium that is trembling-hand perfect. Whenever the settlement systems are run separately by agents that obtain a strictly positive share of the profit ( $m = 1$ ), we have shown that prices  $p_i(\theta_i)$  are strictly increasing in  $\theta_i$ . Hence, prices fully reveal the costs of settlement. Hence, ex-post efficiency requires that  $y_i(a, p) = 1$  if and only if  $p_i < p_j$ . This fact allows us to implement an ex-post efficient merger for all  $\theta$ .

**Theorem 3.** *An ex-post efficient merger is strongly implementable as a market outcome.*

*Proof.* Consider the following mechanism. Define the action sets of player  $i$  to be  $A_i = \{0, 1\}$  for all  $i$ . If any player  $i$  chooses  $a_i = 0$ , set  $m((0, a_j), p) = 0$  (i.e. no merger takes place and no agent is hired),  $t_i((0, a_j), p) = \bar{p}$ ,  $y_i((0, a_j), p) = 1$  and  $\alpha_i((0, a_j), p) = 0$ . Player  $i$ 's payoff is then  $\bar{p} - \theta_i$ . We have to show that player  $i$  obtains a strictly higher pay-off from choosing  $a_i = 1$  if the other player also chooses  $a_j = 1$ .

If both players choose 1, set  $m(\mathbf{1}, p) = 1$ . Set  $\alpha_1 = \alpha_2 = \alpha > 0$ . Given agent  $i$  obtains a share of profits from settlement equal to  $\alpha > 0$ , she strictly prefers to maximize profits and quote the Bertrand equilibrium price  $p_i$  which is strictly increasing in  $\theta_i$  by Proposition 1. Hence, we can express transfers and settlement decisions equivalently as functions of  $\theta$ , where  $p_i = \frac{\theta_i + 1}{2}$  for all  $i$ . Hence, we can set  $y_i(a, p) = 1$  if and only if  $p_i < p_j$ .

Consider transfers for both players given by

$$t_i(\mathbf{1}, \theta) = \frac{(2+d)}{2}(\bar{p} - \theta_i) + \Delta(\theta)/2$$

for all  $i$ , where  $\Delta(\theta)$  is the total net gain from paying the agents and realizing the cost savings given by

$$\begin{aligned} \Delta(\theta) &\equiv (2+d) \sum_{i,j} \left[ \frac{1}{2}\theta_i - y_i(\mathbf{1}, \theta)p_i + (1 - \alpha_i)[y_i(\mathbf{1}, \theta)(p_i - \theta_i)] \right] \\ &= (2+d) \sum_{i,j} \left[ \frac{1}{2}\theta_i - y_i(\mathbf{1}, \theta)\theta_i - \alpha_i y_i(\mathbf{1}, \theta) \frac{(1 - \theta_i)}{2} \right]. \end{aligned}$$

Then, independent of  $d$ ,  $t_i(\mathbf{1}, \theta) > 0$  for all  $\theta$  as long as  $\alpha$  is close enough to 0, since  $\bar{p} > 1$ . Note also, that by definition of  $\Delta(\theta)$  all revenue is distributed among the two players. Hence, the market mechanism we specified is feasible.

Finally, strong implementation in perfect Bayesian Nash equilibrium requires strong individual rationality. Hence, we have to verify that

$$\int t_i(\mathbf{1}, \theta) d\theta_j = (1 + \frac{d}{2})(\bar{p} - \theta_i) + \int \frac{\Delta(\theta)}{2} d\theta_j > (\bar{p} - \theta_i)$$

for all  $\theta_i$ . Since ex-post efficiency requires  $y_i(\mathbf{1}, \theta) = 1$  if and only if  $\theta_i \leq \theta_j$ , we have

$$\begin{aligned} \int \Delta(\theta) d\theta_j &= (2+d) \left[ \frac{1}{4} - \frac{\theta_i}{2}(1 - \theta_i) - \alpha \left( \int_{\{\theta_i < \theta_j\}} \frac{(1 - \theta_i)}{2} d\theta_j + \int_{\{\theta_i > \theta_j\}} \frac{(1 - \theta_j)}{2} d\theta_j \right) \right] \\ &= \frac{2+d}{2} \left[ \frac{1}{2} - \theta_i(1 - \theta_i) - \alpha(1 - \theta_i + \frac{\theta_i^2}{2}) \right] \end{aligned}$$

for all  $\theta_i$ . This expression is minimized for  $\theta_i^* = (1 - \alpha)/(2 - \alpha)$ . Hence, for  $\alpha$  low enough this expression is strictly positive for  $\theta_i^*$  which concludes the proof.  $\square$

The intuition for this result is as follows. If the firms decide to cast off their settlement platforms and merge, the merged platform will purchase settlement as an input in its production

for a price  $\min\{p_i, p_j\}$ . Provided their profit share is strictly positive, the agents prefer to truthfully reveal the costs by quoting the Bertrand price. Hence, settlement can be provided efficiently at the lowest cost and total profits can be shared within the merged firm through transfers depending on the true costs.

It is crucial here that the agent has an incentive to quote the Bertrand price while the players do not have to monitor the agent. This is achieved by giving the agent a strictly positive share of the profits. Furthermore, this also allows the players to tie their hands, i.e., they can credibly commit not to exploit their informational advantage. Hence, by delegating the operation of settlement platforms to agents that share the profits, the players are able to overcome the barriers that prevented the ex-post efficient merger.

Finally, observe that the result is true even if there are only gains from cost savings when the firms merge, i.e., if  $d = 0$ . Even though there are no gains in revenue if  $\theta_i = \theta_j$ , this event has measure 0 for all  $\theta_i \in [0, 1]$ . Hence, the expected gain from merging is always strictly positive and the agent can be promised a strictly positive share ( $\alpha > 0$ ) of profits from settlement without making an expected loss from separating trading and settlement. The agents also will participate, since their expected payoff from running the settlement platform *before* they learn  $\theta_i$  is strictly positive. This is due to the fact that the event  $\theta_i = 1$  has measure 0 and serving all the market has positive probability for all  $\theta_i < 1$ .

## 6 Discussion

We conclude with some final remarks. Our mechanism to implement the merger depends only on the fact that one can delegate a decision (here settlement at price  $p$ ) to an agent. Any other mechanism that gives the proper incentives to the agents to reveal their private information can also achieve the merger. We choose, however, a Bertrand game between the agents as the mechanism to show that a competitive market can just be such a mechanism.

One shortcoming of our result is that we allow the profit share for agents to be arbitrarily small, but strictly positive. If the agents had a strictly positive outside option, this would

impose a strictly positive lower bound on the profit share  $\alpha$ . Whenever this lower bound is large enough, an ex-post inefficient merger between the platforms might be better than merging via a market mechanism.

It is worth mentioning that our results are robust to more general specifications of demand functions. Crucial is here that the true costs of the vertical silos is not immediately fully revealed through the price quoted on the market. Similarly, additional costs from merging will not change our results provided these costs are not too large relative to the expected gains from merging.

Even though we analyze the effect of private information regarding settlement costs, our framework applies directly to a setting where only the costs for trading are private information. The interpretation of this paper is then that vertical silos prevent the efficient consolidation of settlement structures. The experiences of the US consolidation of the settlement structures can be seen as evidence for this interpretation of our findings. In the 1970s, the New York Stock Exchange, the American Stock Exchange as well as the National Association of Securities Dealers all operated their own clearing and settlement structures for exchanges originating from their trading platforms. In 1976, these were merged into a new company called the National Securities Clearing Corporation. Over time, the clearance and settlement operations of other regional vertical silos were separated from trading platforms and consolidated with the NSCC.

A different example presents the case of the Nordic exchange, Norex, which is a joint venture of Scandinavian and Icelandic exchanges. Here, only the trading operations are merged, whereas the settlement arrangements are separate and still owned by the respective exchanges. Given our results, this may be interpreted as evidence that a full merger of vertical silos is not possible due to vested interests arising precisely in the area of settlement. The merger of trading operations nevertheless took place due to the prospect of an increase in trading volumes.

Finally, it is interesting to speculate how our theory is related to the recent de-mutualization of exchanges. Exchanges are now operated as profit-oriented companies rather than as mutually owned enterprises. Hence, de-mutualization can explain the recent drive towards horizontal

consolidation of trading, clearing and settlement. While de-mutualization could be the driving force behind horizontal mergers, we exhibit vertical integrated structures as a potentially important barrier to this process. In future work, this could well lead to a general theory of the boundaries of firms based on the findings established here.

## 7 Appendix

### Proof of Proposition 1:

*Proof.* Let  $\hat{\theta}_i > \theta_i$ . Let  $p_i(\theta_i)$  be the equilibrium strategy of agent  $i$  having costs  $\theta_i$ . Then it must be that

$$\begin{aligned} & (p_i(\theta_i) - \theta_i)P(p_j(\theta_j) > p_i(\theta_i)) + \frac{1}{2}(p_i(\theta_i) - \theta_i)P(p_j(\theta_j) = p_i(\theta_i)) \\ & \geq (p_i(\hat{\theta}_i) - \theta_i)P(p_j(\theta_j) > p_i(\hat{\theta}_i)) + \frac{1}{2}(p_i(\hat{\theta}_i) - \theta_i)P(p_j(\theta_j) = p_i(\hat{\theta}_i)) \end{aligned}$$

which is equivalent to

$$\begin{aligned} & (p_i(\theta_i) - \theta_i)P(p_j(\theta_j) > p_i(\theta_i)) + (p_i(\theta_i) - \theta_i)P(p_j(\theta_j) \geq p_i(\theta_i)) \\ & \geq (p_i(\hat{\theta}_i) - \theta_i)P(p_j(\theta_j) > p_i(\hat{\theta}_i)) + (p_i(\hat{\theta}_i) - \theta_i)P(p_j(\theta_j) \geq p_i(\hat{\theta}_i)). \end{aligned}$$

similarly we must have

$$\begin{aligned} & (p_i(\hat{\theta}_i) - \hat{\theta}_i)P(p_j(\theta_j) > p_i(\hat{\theta}_i)) + (p_i(\hat{\theta}_i) - \hat{\theta}_i)P(p_j(\theta_j) \geq p_i(\hat{\theta}_i)) \\ & \geq (p_i(\theta_i) - \hat{\theta}_i)P(p_j(\theta_j) > p_i(\theta_i)) + (p_i(\theta_i) - \hat{\theta}_i)P(p_j(\theta_j) \geq p_i(\theta_i)). \end{aligned}$$

Subtracting the terms of the second inequality from the ones of the first to preserve inequality, we obtain after collecting terms

$$(\hat{\theta}_i - \theta_i) \left[ P(p_j(\theta_j) > p_i(\theta_i)) - P(p_j(\theta_j) > p_i(\hat{\theta}_i)) + P(p_j(\theta_j) \geq p_i(\theta_i)) - P(p_j(\theta_j) \geq p_i(\hat{\theta}_i)) \right] \geq 0.$$

This implies  $p_i$  is non-decreasing, since the inequality is only fulfilled if  $p_i(\hat{\theta}_i) \geq p_i(\theta_i)$ .

Next, we show that the equilibrium strategy  $p_i(\theta_i)$  is continuous. Suppose not. Then, there exists  $\hat{\theta}_i$  such that  $\lim_{\theta_i \uparrow \hat{\theta}_i} p_i(\theta_i) = p' \neq p'' = \lim_{\theta_i \downarrow \hat{\theta}_i} p_i(\theta_i)$ . Assume that  $p_i(\hat{\theta}_i) = p'$ . The

proof for the other case is identical. Since there is no  $\theta_i$  that sets  $p_i \in (p', p'']$ , there does not exist a  $\theta_j$  that sets  $p_j \in (p', p'')$ .

Suppose now,  $\hat{\theta}_i$  sets a price  $p' + \varepsilon < p''$ , where  $\varepsilon > 0$  and sufficiently small. The additional pay-off for  $\hat{\theta}_i$  is given by

$$(p' + \varepsilon - \hat{\theta}_i)P(p_j(\theta_j) \geq p'') - (p' - \hat{\theta}_i)P(p_j(\theta_j) \geq p'') - \frac{(p' - \hat{\theta}_i)}{2}P(p_j(\theta_j) = p').$$

If  $P(p_j(\theta_j) = p') = 0$ , the additional pay-off is strictly positive.

Suppose  $P(p_j(\theta_j) = p') > 0$ . Then, consider  $\hat{\theta}_i$  choosing  $p' - \delta$ , where  $\delta > 0$  and sufficiently small. The additional pay-off is then given by

$$\begin{aligned} & (p' - \delta - \hat{\theta}_i)P(p_j(\theta_j) > p' - \delta) + \frac{(p' - \delta - \hat{\theta}_i)}{2}P(p_j(\theta_j) = p' - \delta) - \\ & (p' - \hat{\theta}_i)P(p_j(\theta_j) > p') - \frac{(p' - \hat{\theta}_i)}{2}P(p_j(\theta_j) = p') \\ & \geq (p' - \delta - \hat{\theta}_i)P(p' \geq p_j(\theta_j) > p' - \delta) - \delta P(p_j(\theta_j) > p') - \frac{(p' - \hat{\theta}_i)}{2}P(p_j(\theta_j) = p') \\ & \equiv \Gamma(\delta). \end{aligned}$$

Letting  $\delta \rightarrow 0$ ,  $\Gamma(\delta) \rightarrow \frac{(p' - \hat{\theta}_i)}{2}P(p_j(\theta_j) = p') > 0$  by assumption. Hence, for  $\delta$  close to 0,  $\hat{\theta}_i$  is better off setting  $p' - \delta$ . This implies that it was not optimal for  $\hat{\theta}_i$  to set  $p'$  in the first place. A contradiction.

Finally, to show that the equilibrium strategy  $p_i(\theta_i)$  is strictly increasing, note first that  $p_i(\theta_i) \geq \theta_i$  for all  $\theta_i$ . Otherwise, some  $\theta_i$  would obtain a negative pay-off which he could improve upon by setting  $p_i(\theta_i) = \theta_i$  irrespective of players  $j$  strategy. Suppose now that  $p_i(\theta_i)$  is constant on some interval, i.e.,  $p_i(\theta_i) = \tilde{p}$  for  $\theta_i \in [\underline{\theta}_i, \bar{\theta}_i]$ ,  $\underline{\theta}_i < \bar{\theta}_i \leq \tilde{p}$ . Note that  $\tilde{p} > 0$  since otherwise some type in the interval will have a strictly negative pay-off. Consider any type  $\theta_j$  that sets his best response to  $p_j(\theta_j) = \tilde{p} > \theta_j$ .

If type  $\theta_j$  sets a price equal to  $\tilde{p} - \varepsilon > \theta_j$ , where  $\varepsilon > 0$ , he obtains an additional payoff equal to

$$\begin{aligned} & (\tilde{p} - \theta_j) [P(\tilde{p} \geq p_i(\theta_i) > \tilde{p} - \varepsilon) + P(\tilde{p} > p_i(\theta_i) \geq \tilde{p} - \varepsilon)] - \\ & \varepsilon [P(p_i(\theta_i) > \tilde{p} - \varepsilon) + P(p_i(\theta_i) \geq \tilde{p} - \varepsilon)] > (\tilde{p} - \theta_j)P(\tilde{p} \geq p_i(\theta_i) > \tilde{p} - \varepsilon) - 2\varepsilon. \end{aligned}$$

Since  $\tilde{p} - \theta_j > \varepsilon$  and  $P(\tilde{p} \geq p_i(\theta_i) > \tilde{p} - \varepsilon) > P(\tilde{p} = p_i(\theta_i)) > 0$ , the additional payoff is strictly positive for  $\varepsilon$  sufficiently close to 0. Hence, setting  $p_j(\theta_j) = \tilde{p}$  can not be optimal for  $\theta_j < \tilde{p}$  given the best response  $p_i(\cdot)$  of  $i$  and we have  $p_j(\theta_j) < \tilde{p}$  for all  $\theta_j$ .

If  $\tilde{p} \geq 1$ , it follows that for some  $\theta_i \in [\underline{\theta}_i, \bar{\theta}_i]$  it is better to set  $p_i(\theta_i) < \max_{\theta_j} p_j(\theta_j) \leq \tilde{p}$  for any strategy  $p_j(\theta_j) \leq \tilde{p}$ . Thus,  $p_i(\theta_i) = \tilde{p}$  was not optimal for some  $\theta_i$ , a contradiction.

Let  $\tilde{p} < 1$ . Suppose  $\theta_j = \tilde{p}$  sets a price equal to  $p_j(\tilde{p}) = \tilde{p}$ . Then, increasing his price by  $\varepsilon > 0$  yields an additional pay-off equal to

$$\varepsilon P(p_i(\theta_i) > \tilde{p} + \varepsilon) + \frac{\varepsilon}{2} P(p_i(\theta_i) = \tilde{p} + \varepsilon) \quad (7.1)$$

which is strictly positive for  $\varepsilon < 1 - \tilde{p}$  since there is strictly positive mass of type  $i$  above  $\tilde{p} + \varepsilon$ . Hence,  $p(\tilde{p}) > \tilde{p}$  and for all  $\theta_j < \tilde{p}$  we have  $p(\theta_j) < \tilde{p}$ . Thus,  $p_i(\theta_i)$  is discontinuous at  $\theta_j = \tilde{p}$ , a contradiction.  $\square$

### Proof of Lemma 1:

*Proof.* Define  $\tilde{\phi}_i(p) = \phi_i(p) - 1$  for all  $i$ . Then, equation (5.4) can be written as  $\tilde{\phi}_j(p) = (\tilde{\phi}_i(p) - p + 1)\tilde{\phi}'_j(p)$ . The result then follows from Fudenberg-Tirole (1991), p. 225.  $\square$

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