Stateside and cheapside

WHY IS THE COST OF SECURITIES CLEARING AND SETTLEMENT IN EUROPE HIGHER THAN THE US, AND HOW CAN IT BE ADDRESSED? **MARY STARKS** AND **ESSIE LINTON** TAKE A FRESH PERSPECTIVE

The cost of securities clearing and settlement in Europe, compared with the US, has been the subject of intense discussion in recent years. NERA Economic Consulting was commissioned by The Corporation of London to investigate the issue.

Its report, *The Direct Costs of Clearing and Settlement: An EU-US Comparison*, echoes the findings of two previous studies, albeit using a different methodology, that costs are significantly higher in Europe than the US – in some cases up to eight times as much (Lannoo and Levin, 2001; London Stock Exchange, 2002).

This difference in costs has traditionally been calculated on the premise that a single securities market in Europe would be comparable to that in the US – the implication being that the differential represents the cost of maintaining national securities markets in Europe. This comparison has limitations, however, as there are important differences between the US and European markets.

The benefits of integration

Further integration in the European market could lead to substantial cost savings for investors. Increased integration implies higher benefits from the economies of scale involved in processing. Such a market would also avoid the specific costs associated with trading across national borders. NERA's research estimated, for the first time, the differential between European and US costs using a "bottom-up" approach based on published tariff information. It looked at a single transaction, settled through a variety of mechanisms, that gave a more detailed view than a "top-down" approach based on the analysis of accounting data at the institutional level. The approach facilitated the consideration of important non-quantifiable factors affecting overall costs to the investor, such as the impact of a central counterparty.

NERA found that clearing and settling a domestic transaction in Europe costs between €0.35 and €0.80; in the US this is about €0.10. This difference is even more striking when one considers that a cross-border European trade costs between €0.57 and €33.

NERA's results also revealed a high degree of variation in European settlement costs on a domestic and cross-border level. This means it is difficult to estimate the total or average transaction costs for investors – depending as it does on the volume of business transacted on each market, using each settlement method.

For domestic transactions, this variation in costs is mainly a result of the availability of net settlement. Where net settlement is available, and tariffs are calculated according to the number of net transactions – for example on the Euronext markets – customers can achieve a significant discount. Other differentiating factors include size of market and the level of straight through processing – an important aspect of quality of service.

THE PROCESS AND ITS FUTURE

The clearing and settlement process starts the moment after the execution of a trade and culminates with the final, irrevocable, exchange of cash and assets between counterparts to that trade. The process includes the finalizing of obligations of each party to the transaction (clearing) and the final transfer of obligations (settlement).

The publication of the second *Consultative Communication on Securities Clearing and Settlement* by the EC indicates the high priority attached to European clearing and settlement. Internal market commissioner Frits Bolkestein said earlier this year: "There will be no real single securities market in the EU unless we can make cross-border clearing and settlement as efficient, safe and cost-effective as at the national level."

Wall Street shuffle: clearing and settlement costs are up to eight times as expensive in Europe than the US

For cross-border transactions the picture is more complicated. Where no direct links exist between depositories, investors are forced to use agents either directly or via an international central securities depository (ICSD), which raises the costs. Such links are difficult to establish because of technological, legal and regulatory, tax and cultural differences between national markets.

However, it is also the case that agent bank and ICSD fees include additional services provided to the investor. For example, in some cases where transactions are settled cross-border through an ICSD, banking services and other value-added processing services, such as the provision of corporate actions information, may be bundled into the tariff.

Addressing the costs

The underlying causes of high costs within Europe can be ascribed to several factors, which could be addressed by policy actions on a European and national level:

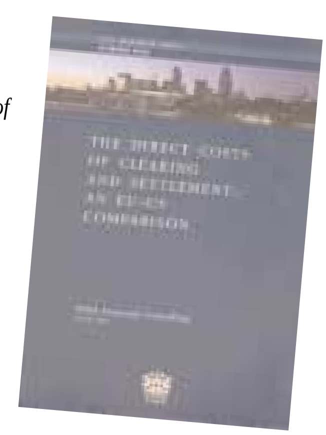
- Lower volumes – since clearing and settlement involves high fixed costs, particularly associated with automated facilities, the higher the volumes, the lower the cost per transaction. The US has significantly greater volumes than most European markets and, therefore, benefits from economies of scale. In particular, volumes of non-domestic trade in Europe are very low compared with volumes traded in the US.
- Legal, regulatory and technical barriers to non-domestic clearing and settlement in Europe – the US market benefits from the consolidation of transaction flows through a single platform with a single set of legal and regulatory conditions. This is not the case in Europe.
- Market structure – the US Depository Trust and Clearing Corporation is user-owned, while European clearing and settlement providers are mostly in private hands, operating on a for-profit basis. European operators may be making higher margins than the US operators, which would have a corresponding impact on charges.

It is important to understand the limits of the scope of NERA's analysis. It considered only the costs of clearing and settling a model equity transaction, and measured only the direct costs associated with such a transaction – it may be that providers with high direct costs have low associated indirect costs and vice versa. Furthermore, quality of service considerations were not reflected in the data, although they are discussed in qualitative terms. NERA does not aim to provide a comprehensive picture of market alternatives.

Despite the difficulty of making true comparisons across different markets, NERA is confident that this bottom-up methodology produces results that are more accurate, if more narrow in scope, than top-down approaches. The bottom-up analysis is a valuable research methodology that generates important insights about unquantifiable differences between tariffs, enabling a deeper understanding of the causes of high cross-border tariffs.

The research could be extended to other aspects of the costs of clearing and settlement and the importance of indirect costs – as well as quality of service. This would give a fuller picture of the true differences between US and European clearing and settlement service provision. **FW**

Lannoo, K., Levin, M. (2001) *The Securities Settlement Industry in the EU: Structure Costs and the Way Forward*. Brussels: Centre for European Policy Studies.
London Stock Exchange (2002) *Clearing and Settlement: Response to the 1st Report of the Giovannini Group*. London: LSE.



NERA's report can be obtained by visiting www.nera.com or contacting europeanenquiries@nera.com.

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