Editorial Introduction

The industrial organization of post-trade clearing and settlement

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Abstract

The introduction to this special issue reviews the literature on the industrial organization of securities market clearing and settlement, covering institutional, theoretical, and empirical contributions, including both papers in this special issue and previous studies. Clearing and settlement is an important but under-researched network industry. Recent theoretical research has characterized the network externalities in clearing and settlement and explored the economic efficiency of various alternative industrial structures. Initial empirical research has identified substantial economies of both scale and scope and important interactions with trading platforms. More research is needed to elaborate these theoretical insights and improve our understanding of the economics of this major industry.
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1. The economic importance of post-trade securities processing

A surprisingly large amount of economic resources are absorbed by costs of trading and settling on securities markets. The accounts of the major investment banks and asset

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managers and of the various providers of clearing and settlement services suggest that the industry spends more than €10bn dollars per year on processing financial trades and ensuring that the resulting obligations are carried out as agreed.[1] Brokerage margins and illiquidity in fragmented markets add a great deal more to the total costs of conducting securities trades.

Despite the economic importance of this industry it remains under-researched. A number of studies have in recent years addressed risk management and systemic risks of post-trade processing and the associated large-value payment systems.[2] There is also of course the large body of work on market micro-structure, examining the relationship between trading arrangements, information revelation, and the determination of prices and trading volumes in financial markets. But there has until very recently been almost no academic literature on the industrial organization of trading and post-trade activities.

The growing interest in the industrial organization of trading and post-trade activities has been driven in large part by the rapid rise of these activities in the agenda for both policy makers and industry leaders. Financial authorities are trying to promote the internationalization of financial markets. This has become a central issue in the European Union. The creation of a single pan-European financial market was one of the major economic goals of the creation of the single European currency, but to date this objective is frustrated, amongst other reasons, by the absence of any pan-European infrastructures for trading and post-trade processing.

The industry itself is also making considerable efforts to reduce cost and operational risk in trading and post-trade processing. Industry specialists recognize that enormous progress can be made on both goals, by adopting standardized automated processing with minimum manual intervention, so-called straight-through processing (STP) from trade to settlement.[3] But problems of co-ordination and of overcoming vested interests have limited progress towards STP. As the debates documented in the annual industry SIBOS conferences indicate, many barriers remain and the adoption of STP remains partial.[4]

The subject of industrial organization of trade and post-trade securities processing is therefore both timely and of great policy and business relevance. The challenge taken up by the various research papers included in this special issue has been to apply tools of industrial organization, both theoretical and empirical, to improve our understanding of this industry. These efforts help to both clarify business issues and to guide policy

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[1] Precise quantification is difficult both because of lack of public domain data and the great variety of different securities transactions. Several studies of the direct costs of clearing and settlement in Europe are reviewed in Annex I of European Commission (2006b). London Stock Exchange (2002) report annual direct costs (operating income of the various suppliers of clearing and settlement) in 2000 of €1.9bn for the European Union and of €0.7bn for the US. Industry sources (see for example the various consultation responses to the European Commission (2006b), on the commissions website) suggest that these direct costs account for less than one quarter of the total processing costs of trade and post-trade activities. Taking account of securities trading in the rest of the world therefore suggests that the total processing costs of the industry are well in excess of €10bn per annum.

[2] A recent contribution, presented at the 2005 Cass conference, is Devriese and Mitchell (2006).

[3] See Group of Thirty (2003).

[4] SIBOS, the annual global conference of the financial transactions industry, organized by the payments standards organization SWIFT, attracts more than 5000 delegates annually. The SIBOS webpages, on www.swift.com, contain a huge amount of material about both payments and the processing of securities and derivatives markets.