FINANCIAL TIMES

A wind of change is blowing through Europe, which finds . . .

Clearers at the crossroads

EUROCLEAR AND Cedel, the two international clearing organisations, have long dominated clearing and settlement in Europe. From their solid foundations in the Euromarket, they have been expanding into a wide range of international securities, including equities.

However, the worldwide trend towards improved local market settlement raises profound questions about their future in supporting investors' interest in Europe's capital markets.

The available evidence suggests that Europe will be a busy investment centre in the 1990s:

- Salomon Brothers estimates that equity transactions will outpace cross-border bond transactions some time in the early 1990s. This should be seen against the present total value of international equities held by foreign investors which reached $830bn in 1989 with turnover of $1,598bn. In addition, cross-exchange trading reached $582bn in the same period.
- Europe attracted a foreign investor to one in every three shares traded during 1989. Foreigners put more money into West German equities during 1989 than into any other single market. In all, Europe attracted more than 50 per cent of all new cash committed to international equities during 1989.
- Equity-based cross border inflows to Europe amounted to $66.3bn in 1959. Most of this investment was made from asset management portfolios ($42.1bn) with the balance from merger and acquisition activity.

EUROPEAN EQUITY MARKETS
Measure of cross-border equity and cross exchange market trading 1989 ($bn)

Market	Capitalisation	Turnover		Cross-exchange trading*	Market turnover rate %
		Total	Foreign investors		
UK	814.3	635.0	141.3	97.9	0.78
France	337.6	221.3	58.2	35.0	0.66
Netherlands	154.5	97.8	61.9	87.5	0.63
Spain	122.9	79.3	23.4	7.4	0.65
Switzerland	170.9	703.8	37.0	8.1	4.12
W. Germany	365.2	628.2	109.3	122.4	1.91
Rest of Europe	459.8	205.9	53.5	25.1	0.45
Total Europe	**2,425.2**	**2,571.3**	**484.6**	**383.4**	**1.06**

*Estimated

Source: Salomon Brothers

The traditional client base of Euroclear and Cedel has been that of professionals dealing predominantly in bonds. The growth in the importance of international equities is diluting the position of these groups as the focal point of settlement and clearing on the international capital market.

There appears to be a developing conflict as the specialist international fund managers and self-managed institutions build their own trading and investment operations around their traditional relationships with domestic exchanges, correspondent banks and global custodians.

This poses an obvious threat to the clearers. The tacit and much-resisted acceptance of institutional investors and asset managers as direct members of the organisations seems to be a calculated reaction to minimise this damage.

With the expected increases in trade will come greatly increased settlement activity. The two clearers have already begun to respond by improving their range of services in an attempt to meet customer needs.

Euroclear has extended the range of stocks in which it offers clearing and safekeeping to some 2,500 stocks across 15 markets. Cedel, which entered the equities business later, also moved to diversify away from the bond markets once the underlying investment pattern was clearly established. It, too, has seen a steady increase in business and now clears trades in over 3,000 equities spread across 12 markets.

The international equities market is made up of two distinct elements: cross-border trades enacted for foreign, non-resident investors in domestic stocks in domestic markets; and the so-called cross exchange market, conducted either on the investor's local exchange or on another specialist exchange, such as SEAQ International, which is foreign to the nationality of the security.

The level of foreign share trading on non-domestic exchanges represented 26.7 per cent of all foreign share transactions in 1989, up from 22 per cent in 1988.

These investment flows are driving Euroclear and Cedel increasingly to see their role as facilitators to equity, as well as bond, investors. Euroclear for instance, already supports the settlement of a significant proportion of SEAQ International business within Europe, particularly for West German investors.

The two clearers are also looking hard at building links with domestic exchanges which will enable participation in the settlement and clearance of cross-border bargains. Links are already in place between a number of exchanges.

However, it remains to be seen whether London's International Stock Exchange (ISE) will allow either clearer direct access to the Taurus system. This must be a key strategic aim for both organisations – the UK continues to be largest trading base for the world's international equity markets.

If the ISE were to allow direct access, there would immediately be available to the UK investment community an electronic trade matching, guaranteed delivery verses payment and cash and stock borrowing service. The economic justification for developing an equivalent system in London for internationally-traded stock would obviously be diminished.

The ISE's natural concerns must include the potential loss of business in Alpha and Beta stocks to Euroclear and Cedel, with the smaller and less liquid stocks remaining in London.

For the moment, the issue is sufficiently guarded by the presence of UK Stamp Duty which, purely on cost grounds, effectively precludes the transfer of UK domestic stocks outside the country; but this tax will be lifted once the overhaul of the London market is complete.

Euroclear and Cedel find themselves at a crossroads. They can continue to reinforce the market perception of themselves as being leading institutions in the clearing business, building their market share of international equity clearing. Or, through direct links with domestic exchanges, they can attempt to maintain their pivotal position in global capital markets.

The two institutions are revisiting their membership rule-books, while at the same time promoting the cost effectiveness and ease of use of their existing electronic systems.

Many banks are, of course, members of both Euroclear and Cedel, which poses the interesting question of whether the clearers can really compete as custodians against their own shareholders.

There is both a threat and a challenge here. Cedel and Euroclear can continue to provide a range of complementary services to their members building upon their existing clients relationships.

Alternatively, they might develop the data manipulation and reporting services which would form the basis of future global custody services. Publicly, officials deny any intention to compete head-on with the custody banks. There is little doubt they are privately considering doing just that.

Simon Thomas