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Competitive pressures in and on the large-value European payments industry

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1. Introduction

Over the past year the launch of SEPA, the introduction of the MiFID and the market turmoil have unleashed strong competitive pressures on the payments industry in Europe and across the Atlantic. Three main market trends are at play:

- The first is the considerable consolidation of the international banking industry brought about by an unprecedented wave of cross-border mergers and acquisitions. In 2007 the top ten banks held 19 per cent of total industry assets, up from 13 per cent in 1996. A few major global financial players, such as large broker-dealers or custodian banks, provide key transaction services for the industry as a whole and are planning to internalize trading activities within infrastructures that they manage directly.
- The second is the cross-border consolidation of stock exchanges and other trading venues, which is cutting across European and North Atlantic borders and could reshape the post-trading industry as well. The two main actors within this industry are the Centralized Securities Depositories (CSDs) and the Central Counterparties (CCPs). In Europe both categories of institutions are subject to cross-border consolidation or other forms of inter-industry association.
- The third is the blurring of some of the traditional geographical segmentations. The American DTCC, which provides clearing, settlement and information services for equities, bonds and OTC derivatives, has recently launched a CCP in Europe, through an affiliate based in London. Major international providers of multicurrency settlement services, such as CLS, are increasingly handling one-way payments in different currencies, operating in locations other than their respective currency areas. Banks working on an international scale offer more and more correspondent banking services for settlement of large-value payments of both single and multicurrency origin.

As a result of these changes, the European payment infrastructures are facing stronger competitive pressures from other European agents as well as from North America. The high degree of competition, together with technological advances, is already leading to a diversification of the services provided and to cost reductions. In Europe some important barriers to the integration of the industry have been removed. However, the end result is uncertain, while new risks and vulnerabilities emerge. Central banks and other authorities are currently adapting their practices to the new environment. Will the developments taking place enhance the system’s efficiency and reliability?. What is particularly challenging is that the trade-off between efficiency and stability has to be solved at the international level, where the optimal economic dimension of markets tends to become cross-currency and cross-continent.

2. The evolving structure in Europe

Let me first deal with the issue of competition within Europe, the progress taking place, and the obstacles to overcome. As we all know, one cannot assess the degree of competitiveness of an industry simply by looking at the numbers of firms operating in that industry. There are many more CSDs, CCPs and ACHs in Europe than in the US, but this does not mean that the European industry is more competitive than that of the US. In fact, the reason why we have so many players in Europe is that the market is highly fragmented. Furthermore, the degree of contestability of each local market is very limited. This situation is rapidly evolving, however. Let us consider the cash payment sector separately from that of securities settlement.

The most notable progress in the direction of European market integration in cash payments has been achieved with the launch of Target2, the main settlement system for large interbank payments, which currently handles about 350,000 transactions daily, corresponding to over €3 trillion. The system implies a significant reduction in the cost of cross-border transactions for its users and a high degree of harmonization of the legal and operational framework in the area of high-value payments. It also meets many of the needs of international banks by allowing them to operate their accounts through a single point of entry. Finally, it operates in two regions and four locations, thereby applying some of the highest standards in terms of operational resilience. Target2 replaces the previous system connecting the national real time gross settlement systems. Of course, one may wonder about the impact of the creation of such a monolithic system on the overall degree of competition within the European industry. In the Eurosystem we are firmly convinced that it will enhance it, for various reasons.

First of all, commercial banks continue to have the choice to settle their transactions through bilateral correspondent accounts – an option that many use, especially small banks. However, while correspondent banking can offer a competitive, advantageous opportunity for some intermediaries, it also tends to concentrate settlement services in a few, large intermediaries, which often grant non-collateralized, intraday credit, thereby increasing the overall counterparty risk. The supply of fully collateralized intraday credit in central bank money therefore enhances the overall soundness of the system without limiting customers' choices. Secondly, Target2 has been designed so as not to alter competition: by offering its services on a cost-recovery and not-for-profit basis, by ensuring equal access to all parties, and by adopting a pricing scheme that does not penalize small market participants. Finally, Euro1, a privately-owned system, offers an alternative to Target2.

The traffic settled in Target has increased continuously since the start of the system. In 2007, Target payments accounted for nearly 90 per cent of the value of all the interbank flows channelled through European settlement systems. However, Target's market share is only 60 per cent in terms of number of payments. This is due primarily to the fact that Euro1 has progressively increased its activity in the field of operations with a lower unit value; indeed, Euro1 traffic has grown by 17 per cent on average in the last two years. Moreover, banks continue to settle payments on a bilateral basis through correspondent banking accounts. According to the last ECB ad hoc survey, 20 per cent of all European payments traffic in 2005 was settled through correspondent banking. Although it is decreasing, it remains a viable alternative for European banks.

The cash payment and settlement area has also witnessed major developments as a result of the advent of SEPA. The standardization of payment instruments it has introduced is speeding up the move towards consolidation. Retail payment infrastructures are now defining interoperability agreements to allow different participants to reach each infrastructure. At the beginning of April an agreement was signed between the Bank of Italy, the Italian ACH Seceti and Equens, a major payment processor operating in the Netherlands and Germany. A growing number of such agreements will enable European banks to reach their counterparts within SEPA and will create a valid additional channel for the execution of payments with positive effects on the overall competitiveness of the market. Other central banks, such as Deutsche Bundesbank and Oesterreichische Nationalbank, are also directly involved in the process.

The situation in the area of securities settlement and in all the "post-trading industry" is much less satisfactory than in that of cash settlement. It is well known that the current fragmentation of this industry puts the European financial sector at a great disadvantage with respect to that of the US and other major financial centres.

Some Eurosystem central banks have been involved in the past in the area of securities settlement. When, twenty years ago, the Bank of Italy launched, with its White Paper, a major reform of the Italian payment system, the area of securities settlement was one of the key sectors involved in the process. The system was later transferred to the private sector, which continues to operate it successfully. However, the Italian system, like most other European systems, is still not adequately integrated with that of other European countries. There is a clear market failure in the present fragmentation of settlement platforms, with a multiplicity of national monopolists and, ultimately, undue costs for all market participants, whether issuers or investors. The Target2-Securities (T2S) project aims to correct that market failure, while at the same time exploiting technical synergies with the Target2 platform.

One may wonder, again, whether this type of activity by central banks will actually enhance overall competition. I would answer yes to that question by stressing a few key points:

- the T2S project concerns *only the settlement phase,* in which central banks either play a role in the cash settlement or have a clear responsibility to ensure the smooth and efficient functioning of the system. Actually, by building and offering to the market common and advanced settlement infrastructures, the Eurosystem *will foster competition*, providing a level playing field and a common set of rules;
- the Eurosystem has already clarified that the CSDs not joining the T2S platform, if any, will be offered the possibility of settling their transactions in central bank money;
- central banks do not intend in any way to enter the competitive market of asset servicing or other value added services linked to security settlement. Competition is expected only to change shape, being based not on the existing fragmentation but on the quality and range of services offered by CSDs to final users.

Some progress in terms of horizontal integration is also taking place among CSDs, perhaps as a response to the Eurosystem initiative to launch Target2-Securities. Recently, a group of CSDs decided to combine several clearing and settlement functions in a cooperative effort (Link Up Markets). By connecting to the common infrastructure, each participating CSD will have access to services of the other participating CSD markets. According to the promoters, Link Up Markets is expected to eliminate differences in communication standards across the markets, while leveraging the existing infrastructures and processes of CSDs. In another development, a number of Nordic CSDs have recently decided to join Euroclear.

Another important component of the post-trading industry is that of the central counterparties. By netting individual exposures and mutualizing possible losses they play an increasingly important role, especially in the current highly volatile market. The Code of Conduct promoted by the European Commission and the MiFID have set in motion some important competitive forces in this segment of the industry. In many countries market participants can now, in principle, choose among central counterparties. The MTS platform has been a pioneer in this respect; other markets, such as the LSE, are taking the same route.[1] This situation is likely to increase the demand for new links.

These developments raise a number of questions. Is such a system of competition sustainable or will it ultimately lead to consolidation? Since in most national markets only one CCP operates, is this competitive process simply a mechanism for choosing who will ultimately become the monopolist? Does the process offer a level playing field for all participants? Will this "struggle to survive" reduce security standards or complicate their assessment by the authorities in charge of system oversight? The experience gained since the introduction of the Code of Conduct does not provide definite answers yet. However, I would like to reflect on some issues that are clearly a cause for concern.

The rationale of achieving market integration by linking existing infrastructures is based on fully exploiting network externalities without forcing industry consolidation or other major industry restructuring, such as the break-up of vertical silos. It is an approach currently being tested in the market, but early indications show that the system of incentives driving the interoperability agreement process is not operating as expected. Before the Code of Conduct came into force, interoperability agreements were reached on a cooperative

[1] The new trading venues Chi-X and Turquoise are introducing pan-European CCPs, working on a stand-alone basis: the EMCF (European Multilateral Clearing Facility), controlled by Fortis Bank, provides all clearing and risk management services on Chi-X; EuroCCP, controlled by DTCC, will do the same on the Turquoise platform. This means that a variety of CCPs will work simultaneously in support of trading in dual-listed stocks.

basis; currently a CCP offering its services on a market is instead forced to enter into agreements with one or more other CCPs wishing to serve the same market. The expectation that the incumbent CCP will erode market share of the other CCP, and a perception of an uneven playing field, are delaying the implementation of these agreements.

From an efficiency perspective, one also has to consider the complexity associated with several CCPs operating on the same market, as experienced by the two CCPs (CCG and LCH.Clearnet SA) operating on the MTS market since 2002. In particular, additional risk management tools are necessary to limit the risks of contagion deriving from a possible malfunctioning of one CCP. Offsetting mechanisms, in terms of margin requirements, need to be introduced when operators use different CCPs to manage more efficiently correlated financial risks. Extensive legal work is needed to regulate the links among CCPs, in a context characterized by very different national laws and contractual rules.

Finally, stronger competitive pressures should not result in a lowering of security standards. In this respect, there are potential systemic implications of building a network of links among CCPs, given the interdependencies among their respective exposures. Overseers and CCP operators must pay attention to these implications, in order to find an appropriate balance between efficiency and risk.

These difficulties should not undermine the process of greater interoperability which has been set in motion. It is too early to tell whether the market will find alternative approaches, such as a cross-border consolidation of post-trading activities. However, if the desired results do not materialize, some corrective action will need to be devised.

3. New global challenges

While the European financial industry is struggling to achieve greater internal integration, a number of important new developments are taking place across the Atlantic. Some institutions, such as CLS and DTCC, are setting up clearing and settlement services in various currencies and operating in different regions. In some cases European institutions directly participate in these initiatives. In others they are studying whether to launch alternative initiatives. What type of pressure will these developments generate for the European payments industry? What types of challenges will central banks face to preserve their ability to properly exercise the oversight of payment systems in the new environment?

CLS, the global multilateral system for settling foreign exchange transactions, has increased its turnover enormously, reaching almost the same settlement value as Target2. Recently, CLS has launched a number of initiatives to expand its business beyond the settlement of foreign exchange transactions and is providing settlement services in single currency transactions originated in the options and credit default swaps markets.[2]

From a public good perspective these developments are welcome insofar as they reduce overall settlement risk. In particular, in the newly published BIS report "Progress in reducing foreign exchange settlement risk", the provision of the settlement service by CLS Bank – which settles 55 per cent of total foreign exchange obligations – is recognized as an important private sector step towards reducing systemic risk. However, these developments are altering the correspondence between the geographical jurisdiction of a central bank and the settlement location of the currency it issues. In normal circumstances and for low volumes of operations this circumstance should not be a reason for concern. But in emergency situations, caused for instance by a malfunction of the system, a central bank may find itself in serious difficulty in ensuring final settlement, especially if operating in very distant time zones. This calls for an enhanced form of cooperation among central banks.

The Eurosystem has clarified its policy guidelines on off-shore systems by issuing some "Policy Principles" for the location and operation of infrastructures settling euro-denominated payment transactions, guided by the need to retain the capacity to control money creation even in the most adverse circumstances. At the same time, the central banks of the major currencies are working to define a strengthened framework for cooperative oversight in order to adapt the information and intervention tools at their disposal to an environment in which major sources of financial instability may be located in countries and currency areas different from the one in which they operate.

[2] A number of other multicurrency systems also operate: some of them settle foreign currency transactions for participants located in their same country (e.g. the EURO-CHATS and the USD CHATS run by the Hong Kong Interbank Clearing Ltd, HKMA); others, operating at regional level, settle multicurrency transactions for participants located in different countries (e.g. the link between the Malaysian RTGS Rentas and the USD CHATS).

Other initiatives have recently been launched in the US under the impetus of the Financial Stability Forum, which stated that “market participants should act promptly to ensure that the settlement, legal and operational infrastructure underlying OTC derivatives markets is sound”. The Chicago Clearing Corporation (CCorp) and The Depository Trust & Clearing Corporation (DTCC) have agreed to facilitate central counterparty services for the over-the-counter (OTC) derivatives market. This initiative would bring about improvements in efficiency and reductions in costs for the settlement of OTC contracts. As a result, DTCC would strengthen its role as the only global institution able to provide clearing and settlement services for a great number of OTC contracts.

This development raises two questions: the first is whether the European post-trading industry will itself be capable of launching similar services and, in that case, whether conditions of open access and level playing field will be guaranteed. The second is whether such an industry development should be mirrored by new forms of cooperation among supervisors operating in different markets.

4. Conclusion

To conclude, let me go back to the question I raised at the beginning of my talk: are the changes currently taking place in the European payments industry giving rise to a more efficient and sound system? As we have seen, the answer is mixed. The most visible progress has taken place in the area of clearing and settlement of cash payments, where both the Eurosystem central banks and the private sector have developed European-wide infrastructures that are handling an increased volume of payments within a harmonized framework. Progress is much slower in the securities settlement and post-trading areas where the market is still highly fragmented and the various initiatives taken to create conditions of interoperability among different infrastructures are not yet producing the desired results.

At the same time, new pressures are arising from initiatives taken in North America but capable of covering the European market. One could envisage a situation in which infrastructures operating outside the euro area could offer better conditions to euro-area participants than those inside the area. This scenario is not unlikely if current segmentations are not overcome and costs reduced. An opportunity to achieve this result is the introduction of Target2-Securities, which could act as a catalyst for the harmonization of securities settlement within Europe in the same way that Target2 has acted as a catalyst to harmonize procedures in cash settlement even under very different legal systems. The opportunity to respond to current competitive pressures by progressing more rapidly towards harmonization and integration should not be missed.