

# The challenging road to an integrated European capital market - are market forces or legislation the key to success?

**Article for the Global Custody Review, April 2006  
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Neelie Kroes and Charlie McCreevy, the European Commissioners for Competition and Internal Market and Services respectively, have recently stated that they will take action before the summer break of this year unless market players come forward with effective and realistic changes to improve the clearing and settlement of securities in the EU. They summarise the reasons for the required changes as follows: "The current fragmented national monopolies in trading infrastructures such as exchanges, clearinghouses and securities depositories, create high costs for the EU economy and represent significant impediments to efficient cross-border trading in the EU. The securities industry needs to accelerate work on removing a number of barriers significantly, and provide a firm timetable for change." While there is unequivocal consent on the need of cost reduction and efficiency increase, the question of how to get there may be answered differently. This article therefore endeavours to analyse the current situation and evaluate the most promising routes to success.

## **A sober assessment of the current situation**

The reports of the Giovannini Group have defined 15 barriers that stand in the way of efficient cross border clearing & settlement and custody in Europe. The private sector has assumed the responsibility for the removal of 6 out of the 15 barriers, while for 9 of them the public sector - both at EU and at national level - is held accountable. This division of labour is a reflection of the respective competences and powers as three types of barriers were identified, i.e. relating to technical requirements / market practice, to taxation and to legal certainty.

For a sober assessment of achievements to date three phases should be distinguished: in a first phase the solutions to remove the barriers have to be worked out and agreed on by the relevant parties; the second phase is tasked with a gap analysis and a timetable for implementing each of the agreed solutions market by market followed by the actual implementation in phase three.

In regard of 5 of the 6 barriers within the responsibility of *the private sector* - different operating hours / settlement deadlines, diversity of IT platforms / interfaces, absence of intra-day finality, different rules governing corporate actions, differences in securities issuance practices - at least the first phase is terminated; a large part of them are currently in phase two or three and in one (differences in securities issuance practices) implementation is concluded. The removal of the barrier caused by different standard settlement periods has been postponed for lack of a compelling business case. *In essence*: Private sector initiatives to harmonise and standardise market practices have started bearing fruit in spite of partly high complexity, e.g. corporate actions processes.

Unfortunately, the same cannot be said with respect to *public sector action*. While the European Commission has established the Legal Certainty Group and the Fiscal

Compliance Group to work on the legal and fiscal barriers - both groups are expected to publish first reports in the near future -, we have not seen any meaningful steps taken by any of the governments of EU member states to remove barriers such as restrictions on the location of clearing and settlement, impediments to remote access or restrictions of withholding tax agents.

Measured against the broader - and ostensibly endorsed - principle and objective of open access and free choice, a key element of the 2004 Communication of the European Commission on clearing & settlement, the current situation still is characterised by de facto silos in regard of the links between exchanges, CCPs and (I)CSDs, virt-x being the only exception offering multiple choice at CCP and (I)CSD level.

### **Accelerating and slowing factors of the process of change**

Competition, consolidation and commitment on the part of both the private and the public sector are the key factors to accelerate the process of change. The case of Euroclear's IT systems integration project demonstrates the interaction between consolidation and harmonisation / standardisation; conversely a more harmonised and standardised post trade environment will facilitate further consolidation of the European securities infrastructure. Commitment as well as commercial and political will are highly important in all those areas where change is the result of consent - an often cumbersome process - and not of enforcement based on respective authority. Moreover, instruments of cooperation and coordination like the CESAME Group are indispensable to warrant the efficiency of the process.

The slowing elements are partly difficult to cope with as they may appear well disguised when consent to high level objectives contrasts with inertia or even obstruction at the level of transposition into concrete steps. Commercial interests built on the existing fragmentation and inefficiencies, ill-perceived national interests and intra-European competition, the 'not-invented-here'-syndrome and cost-benefit asymmetries are further factors slowing the pace of the process of change.

### **Market forces vs. legislation**

Against this background, will market forces or legislative action by the European Commission be the key to success? Preferably market forces: private sector experts - currently at work anyhow, as outlined - know better than any legislator how to exploit cost synergies by way of harmonising and standardising market practices. Market structures, e.g. the scope of services of CSDs, should be left to market forces and competition to maximise the reduction of cost.

Will market forces alone thus warrant an efficient and integrated European capital market? The answer is most likely negative as they will hardly have the power to enforce open access and free choice throughout the European securities markets. However, there may be more effective, swifter and more bespoke means of action for Commissioners Kroes and McCreevy than legislation by way of a directive or framework directive to exert their influence. Market practitioners know the most obvious examples of restrictions on withholding tax agents, of impediments to remote

access and, more generally, of the most formidable cost drivers - it may be time to name and address them in detail at the risk of being 'politically incorrect'. This route should prove to be less time consuming than legislation - apart from avoiding differences in transposing a directive into national law. Market forces should also be given a chance to break up the current lack of competition and choice in directing the flow of trades from exchanges to CCPs and (I)CSDs. In both cases very carefully tailored and targeted legislation may, however, be required as a means of last resort to achieve the respective objectives fully and in time.

## **Conclusions**

It is time, no doubt, to accelerate the pace of change towards a liberalised and integrated European capital market. The post-trade part of the value chain holds the key to successfully achieve this objective. To date the limited action of the public sector do not compare to the efforts made by the private sector to remove the barriers defined by the Giovannini Reports. Swift and bespoke actions are imperative to remove the barriers for which national governments of EU members states are accountable and to make open access and free choice for market users reality rather than a catch-word - 'national champions' will hopefully not extend to the securities services industry. Legislative action as a means of last resort may be required to enforce a truly competitive environment.