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Staying on top of money world

By For The Straits Times, Ivan Png & Joy Cheng

THE first five days of this month were momentous for financial exchanges. Euronext, which operates the stock exchanges in Amsterdam, Brussels, Lisbon and Paris and the Liffe derivatives exchange, accepted a 7.9 billion euro (S$15.9 billion) offer from the New York Stock Exchange (NYSE).

The Singapore Exchange (SGX) announced that it had scrapped the development of a multi-million-dollar trading system by SDG Software Technologies of India and had contracted for a different system from OMX of Sweden.

The NYSE's takeover of Euronext is just the latest in a stream of consolidations. Nasdaq owns 25 per cent of the London Stock Exchange (LSE). In 2002, Euronext acquired Liffe, the London International Futures and Options Exchange. Euronext itself is the product of a merger among three European exchanges. Indeed, Deutsche Borse had offered to acquire Euronext, but was rejected.

The consolidation of financial exchanges is being driven by the substantial fixed costs of technology. Exchanges can reap economies of scale and scope by spreading these fixed costs over larger trading volume, more share listings and more financial products such as derivatives.

Consolidation has been greatly facilitated by the wave of corporatisations. Until the 1990s, most stock and derivatives exchanges were 'mutually' owned by the brokers who traded on the exchange. Then, a wave of de-mutualisation and corporatisation separated ownership from use of trading services.

Indeed, in 1999, the Stock Exchange of Singapore and the derivatives exchange, Simex, were de-mutualised and then merged to form the Singapore Exchange. The following year, the SGX became a publicly traded company listed on itself.

The mutual form of organisation impeded consolidation among exchanges. Any merger would require the approval of the members of the exchanges involved. By contrast, shares of a listed corporatised exchange can be easily bought and sold.

Besides consolidation, the organisational architecture of financial exchanges is being driven by another trend - vertical disintegration. Buying and selling shares, derivatives and other financial instruments on an exchange actually involves three services - trading, clearing and settlements.

Traditionally, exchanges provided all three services in a vertically integrated 'silo'. Fixed costs of technology are driving a trend towards specialisation. Exchanges are tending to specialise in trading, while other entities specialise in clearing and settlement.

In 2003, Liffe and Euronext merged their clearing services, London Clearing House and Clearnet, to form LCH.Clearnet. This is now Europe's largest clearing house. LCH.Clearnet advocates a single pan-European clearing house to fully exploit the fixed costs of clearing services.

Euronext specialises in trading while outsourcing clearing to LCH.Clearnet, and custody and settlement to various national depositories. The LSE has recently gone a step further with a proposal to give traders a choice of clearing with either LCH.Clearnet or SIS x-clear.

However, Deutsche Borse abides by the vertically integrated model. Its wholly owned subsidiary Clearstream provides custody and settlement services. A strategic difference over vertical integration was one of the reasons why Euronext rejected the Deutsche Borse takeover offer. The Hong Kong and Singapore exchanges also follow the vertically integrated model.

By contrast with the rash of activity among European and US exchanges, the situation in the Asia-Pacific seems relatively quiet. The region's largest market, the mammoth Tokyo Stock Exchange, is only now replacing share certificates with a de-materialised record system.

Yet, Asia-Pacific exchanges confront the same economic imperatives as European and US exchanges - the large fixed costs and complexity of technology, and competition for listings, new products and trading.

What is impeding consolidation and vertical disintegration among Asia-Pacific exchanges? Could it be national protection? This would be very short-sighted.

Exchanges face competition in listings. The SGX may have a monopoly over listings in Singapore, but does not have a monopoly over the listing of Singapore companies. Just as Chinese companies list in Singapore, Singapore companies could list elsewhere. The LSE's Alternative Investment Market has attracted smaller companies from all over the world.

Exchanges face competition in trading as well. Traders in US-listed shares may deal directly with one another, or indirectly through 'over the counter' brokers or new institutions such as Liquidnet, Posit and Pipeline. More than half of trading in British- and German-listed shares takes place outside the respective exchanges.

Should Asia-Pacific exchanges merge to reduce the cost of providing trading systems? (The NYSE and Euronext expect to save 195 million euros a year by consolidating trading systems and data centres.)

Should Asia-Pacific exchanges establish a regional clearing house - a win-win proposition that would lower the costs for trading throughout Asia?

It is time for exchanges in our region to address these issues of whether to consolidate and the appropriate degree of vertical integration. The risk of doing nothing is to be left behind by competition in the international marketplace.

Dr Ivan Png is a professor of business policy and information systems at the National University of Singapore. Ms Joy Cheng is managing partner of Economic Analysis Associates, LLP, and consulted on the de-mutualisation of the Hong Kong Futures Exchange. The opinions expressed here are personal.
