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SGX should hive off clearing function

Resulting independent unit can tap Singapore's reputation, communications set-up to become clearing capital of Asia

By IVAN PNG AND JOY CHENG

THE Hong Kong Exchanges (HKEx) are worth US$16.9 billion, a cool US$1.5 billion more than the NYSE Euronext. But, the value of shares listed on the HKEx is US$2.4 trillion, which is just 13 per cent of that on the NYSE/Euronext.

The Singapore Exchange (SGX) is worth US$5.6 billion, almost as much as Nasdaq. But the value of shares listed on the SGX is a mere US$500 billion, which is 85 per cent less than that on Nasdaq.

What accounts for these disparities? Better growth prospects in Asia? Lower labour costs? Better management?

Or because HKEx and SGX have monopolies over both trading and clearing? Trading refers primarily to the routing of orders, and the matching and allocation of trades.

In contrast, clearing involves the management of post-trade settlements, risk margining, trading netting, and failure handling.

Trading and clearing are two distinct services. There is no technical or economic reason why the same entity should provide both services. Indeed, all securities traded on the NYSE and Nasdaq are cleared by an independent entity - the Depository Trust & Clearing Corporation (DTCC).

The DTCC arose from the outsourcing of the clearing services of the various United States regional exchanges into a single consolidated entity. Today, the DTCC services 3.5 million securities issues, valued at US$40 trillion, from the world over. In 2007, the DTCC cleared more than US$1.86 quadrillion worth of securities transactions.

On the other hand, Hong Kong and Singapore follow a model of vertical integration. Each exchange provides both trading and clearing services under a common ownership. An important consequence of the vertical integration model is that the clearing business serves only the domestic market.

European exchanges present a medley of practices. Referring to the chart above, the other outlier in terms of the value of the exchange relative to the value of the listed securities is the Deutsche Borse. It follows the vertically integrated model, and provides clearing services through wholly owned subsidiary Clear-stream.

Meanwhile, the London Stock Exchange outsources its clearing to LCH.Clearnet. Over the last two years, Euronext has reduced its ownership stake in LCH.Clearnet from over 40 per cent to just 5 per cent. Owing to information technology and other large fixed costs, clearing is a business that is subject to substantial economies of scale.

The DTCC provides clearing services for securities traded on the NYSE and Nasdaq.

Leveraging its fixed costs, the DTCC is taking on the European market. It is offering clearing services to European exchanges at a price of just nine US cents per side, which is less than half the fee charged by European clearers and HKEx, and a fraction of the fee charged by SGX.

There are only two ways to run a business subject to strong economies of scale. Get big or get out. Economies of scale are driving consolidation in industries as diverse as banking, insurance, and logistics.

There is no sustainable way to run a business with large fixed costs on a small scale - unless it has a government-sanctioned monopoly. This is the story of the vertically integrated Hong Kong and Singapore exchanges.

In civil aviation, our government rightly took the view that airlines and airports are two distinct businesses in separate markets. The government promotes Changi Airport, but Singapore Airlines is left to fend for itself.

Shouldn't we adopt the same policy towards organised financial markets? The trend is clear - shares can be traded on multiple exchanges or even off exchanges, electronically.

We should break up the SGX into separate companies - specialising in trading and clearing. The clearing company should be required to compete for the business of the Singapore Exchange, along with any other clearer, such as DTCC.

We should not see this as a threat but as a great opportunity. Freed from the Singapore Exchange, the new clearing company could compete for business throughout the region.

Our reputation for integrity and efficiency and the superb telecommunications infrastructure is known worldwide. Our airport and port have leveraged these advantages to make Singapore into a transport hub for the region. In the same way, we should aspire to become the clearing capital of Asia.

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