Institutional Investor

Transaction Performance

The Changing Face of Trading

Globalization and Cross-Border Exchanges

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As investors trade increasingly across national boundaries, reaching now 1.5 million trades per day and US$30 trillion a year, they visibly strain the ability of current facilities to process trades, underscoring the need for new powerful solutions. EDS Capital Markets reports that $1.8 trillion worth of cross-border trades remain outstanding and unsettled every business day, or about 16% of all such trades. The costs associated with unsettled trades match or exceed the costs involved in processing all other trades, and run into the billions.

It should be obvious that better global facilities are needed, and equally obvious that the exponential growth of cross-border trading makes such need an elusive and ever expanding target. But who benefits from the cross-border exchanges?

The benefits go to the entire industry. Each global trader benefits from new technologies that replace outdated methods and lead to better, faster, and cheaper ways of doing business. The technology firms that create and sell such solutions also benefit, and so do their clients—the institutions, banks, brokers, asset managers, and corporations who use them. Suffice it to observe that innovative industry associations have emerged such as the Global Straight Through Processing Association (GSTPA), as well as promising and valuable joint ventures between the private and the public sectors such as Omgeo, which involves Thomson Financial and the Depository Trust & Clearing Corporation (DTCC).

As valuable as they are, these initiatives may be only the beginning of things to come. One purpose of this article is to outline what other powerful solutions may be needed to cope with current industry problems. To justify new powerful solutions we need, however, to demonstrate a powerful need.

NEW CAPITAL

The history of cross-border exchange is tied up with the emergence about 20 years ago of floating exchange rates and the Eurobond market. Yet this background belies the real need behind global trading, as it grows by leaps and bounds every year, in expansions and recessions alike, to reach new volumes and new markets. The need, one must recognize, is not driven by exchange rate policies, and does not depend on the creation of global instruments. It is not simply the need to process transactions sooner or more efficiently. It is a more fundamental need.

It is the overwhelming need for cross-border capital, to reach faraway places with the type of capital that is best suited to small and large business alike, the capital that comes from the world's markets, from investors who seek opportunities wherever these may be. This is a source of capital that can replace that provided since World War II by the International Monetary Fund and the World Bank, which emerged in an era led by Keynes and

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Meade and by the Bretton Woods institutions to which they gave birth.

Here is the point. Rather than large banking and political institutions deciding the direction and the depth of capital flows from one nation to another, the cross-border markets offer a *private* capital response to *private* capital needs that is small and flexible and follows only one rationale: the best returns. In other words, the cross-border markets are more than a solution to the processing problem that the industry faces today. They are a fully grown solution to the current crisis of confidence in the Bretton Woods institutions.

EARLY GLOBALIZATION INFLUENCES AND EFFECTS

The world seems to be shaking off the centralized and political type of globalization created by the successful Bretton Woods institutions in the second part of the twentieth century. These institutions have led the world, seeking to replace global wars by global trade. By design, these institutions were dominated by the Anglo Saxon or western world, and followed very successful western economic principles. They satisfied a powerful need, seen with 20-20 vision by the genius of Meade and Keynes: Differences among nations can be sources of gains from trade rather than of wars.

After half a century, the effect is clear. History has witnessed a long and successful expansion of the world economy. The international markets have grown three times larger since World War II, demonstrating the success of the Bretton Woods vision.

Today, the post-World War II institutions may be the victims of their own success. In globalization forums, they now appear as slow, inflexible, and increasingly the cause of rather than the solution to the problems they were designed to resolve. The world needs a private solution to the needs of private capital, a more flexible solution that follows market principles rather than political dictums, no matter how well guided.

The Omgeo private/public initiative as well as the GSTPA may point the way to a more decentralized solution. Solutions are needed to cope with cultural and social diversities better than large and politically driven institutions can. This is why hundreds of new exchanges are emerging. This is why Omgeo and the GSTPA are building technological connectivity to the various actors in this play. This is why the cross-border markets keep growing by leaps and bounds.

The need is real and powerful. It encompasses the entire planet and every single entrepreneur who needs access to the capital markets in a flexible manner that is well adapted to the customer's needs. Small and large firms across the world need to use cross-border markets as a source of financing for ever-growing capital requirements. We require better and more powerful global processing solutions, to help provide the global liquidity that is needed today.

WHAT IS REALLY NEEDED

A powerful need requires a simple solution. Do we need to recreate large and centralized technologies based on expensive equipment and high start-up costs? Do we need the countries of the world to create together a global version of the DTC technology, which made the U.S. the most liquid and efficient trading market in the world, and which emerged from the need to overcome continuous crippling fails and losses in the U.S. markets? Do we need other industry cooperatives to compete with Society for Worldwide Interbank Financial Telecommunications (SWIFT), which encompasses 7,199 users globally, and whose technology has become the *de facto* language that all banks in the world talk among themselves?

The answer is no. The current structures play a crucial role but need not be replaced, replicated, or reinvented in the future. Rather, they can be merged with smaller, more flexible, and distributed types of systems that will vastly enhance their reach and the efficiency of their services.

This seems to be the GSTPA's and Omgeo's vision—and may also be SWIFT's. These groups seem to view the Internet as a way to effective decentralized solutions, solutions that merge easily with legacy systems, and that minimize changes and integration costs as well as wasted time.

Accessibility

The use of highly secure virtual private networks (VPNs) ensures encryption and total confidentiality of highly sensitive trading data. In a VPN, the Internet is used as a road that allows great performance and speed of delivery, rather than the vehicle for data transmission. Equally important is the Internet's facility to achieve universal access, by every computer everywhere in the world.

This universal accessibility is particularly important in a diverse world, where technology differences often track the widespread differences in the nations' gross domestic products. One needs to be able to "plug and play," with no special software and hardware requirements, no development or installation costs. ASP (application service provider) solutions are made to order here, with global data centers providing easy and efficient access, which is available immediately and universally.

Systems

Perhaps as important as the technology wonders that the Internet offers is the ability to achieve a solution that minimizes changes in the way we do business.

Cross-border trading follows a processing cycle that starts in a way similar to the domestic trades in the U.S. today, involving first *order entry*, then *routing*, *prematching*, and *allocation*. Yet the ending is quite different.

After these tasks are accomplished, trade processing undergoes an enormous fundamental transformation from what we know in the U.S. First is the area of *global execution*, which is accomplished by giant networks of broker-dealers loosely organized around the world to "execute" transactions in local markets along with the clearing organization in the particular countries.

After this is completed, the process turns into the global custodian's area of business, the *settlement* cycle, which includes *payments*, *foreign exchange*, and the *physical movement of securities* that are held at their countries of origin by the *subcustodians*. The securities themselves move from one subcustodian bank to another or to the local *Central Securities Depository* (CSD), but always remain in the country of origin. There is, however, no standard communication method for this step of the process, and in some countries physical delivery is still the norm. This explains why the fail rates are so high for cross-border trades.

Global custody networks are loose configurations of subcustodians led by large *global custodians*. They encompass often about 100 subcustodian banks communicating with the global custodians via fax, SWIFT messages, telephone, and even telex. Global custodians are for practical reasons an invention of the Employee Retirement Income Security Act legislation, which protects the safety of pension funds.

After the settlement is completed at a cost that is orders of magnitude higher than what the DTC charges in the U.S., there is asset servicing, also offered by global custodians and their subcustodians. This involves *borrowing and lending of securities* as well as *corporate actions processing*.

The complexity of the task is enormous. Some global custodians receive daily more than 13,000 faxes to complete their settlement cycles. The errors and fails are equally great, and the costs are dwarfed by the size of the assets under custody—today about $40 trillion on a yearly basis. The global custodian market is highly concentrated, with revenues and costs running in the hundreds of millions in each large organization and staff population in the thousands.

Solutions

The Internet can offer a vehicle to link the giant networks of institutions that are today loosely organized for processing a cross-border trade from soup to nuts; to link large networks of global executing broker dealers, one per country; to link large networks of global custodian banks and their subcustodians, also one per country, who execute the final settlement process of the trade.

No need to change the way we do business. The idea is to do things as we do them today, except better and faster, reducing costs and risks, and dramatically improving the services to the final user, the investor.

These solutions can be described as the art of the obvious. They represent a gradual improvement on current systems based on today's available infrastructure and technologies—and can offer needed capital liquidity to a world that needs it, in an era of globalization when large political institutions may have already passed their useful peak.

TRENDS IN CROSS-BORDER TRADING

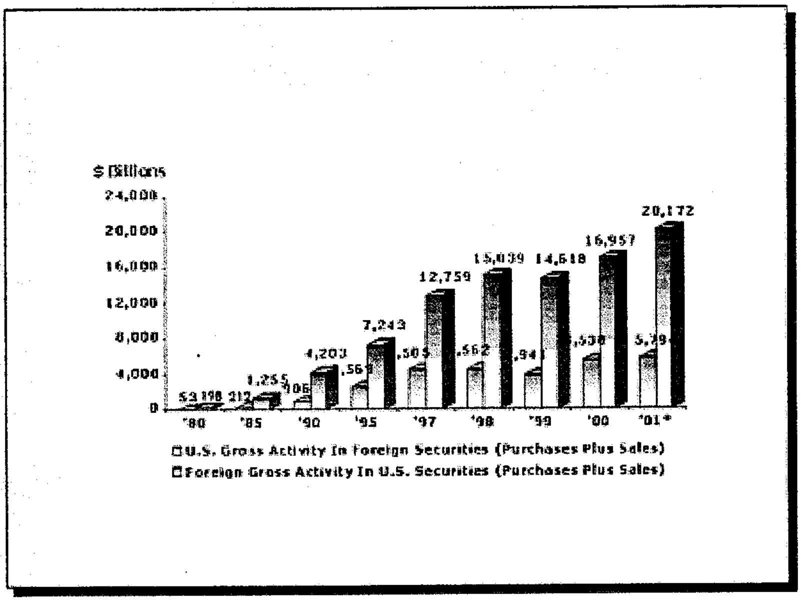
Exhibit 1 shows the trend in U.S. cross-border securities trading since 1980. Acitivity has grown over a hundredfold in two decades.

As Americans' ownership of and activity in securities grew over the past two decades, so too did their activity in foreign securities. From 1980 to today, U.S. gross activity (both purchases and sales) in foreign securities grew from just $53 billion to nearly $5.8 trillion.

As the largest capital market in the world, the U.S. has always been a haven for foreign capital. Here, too, foreign gross activity in U.S. securities, particularly U.S. Treasuries, has also exploded more than a hundredfold from $198 billion in 1980 to $20.2 trillion today.

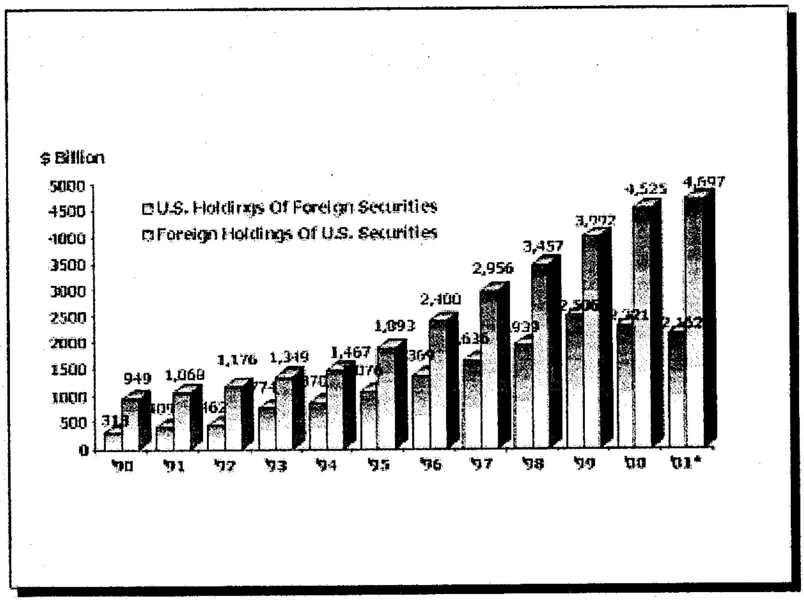
With the explosion of cross-border activity in stocks and bonds came a huge cross-border ownership in the debt and equity of private businesses and government debt. Despite continued increases in both gross activity and net purchases of foreign stocks and bonds by U.S. investors in recent years, the total value of these holdings declined nearly 14% from $2.5 trillion at year-end 1999 to less than $2.2 trillion by mid-year 2001 because of falling securities prices globally (*Exhibit 2*). Although

EXHIBIT 1
Investors Going Global



Source: U.S. Treasury, 2001.
**First Half Annualized.*

EXHIBIT 2
Global and Interconnected Markets



Source: Federal Rserve, 2001.
**First Half.*

the value of U.S. equities also declined, bond prices rose as interest rates fell.

The ongoing net purchases of U.S. securities by foreigners outweighed market declines, and the total value of their U.S. securities portfolio has continued to reach record highs, standing at $4.7 trillion as of mid-year 2001.

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