

Commercial Enterprises vs Industry Utilities – Where is the Border Line?

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Should market utilities be allowed to go into direct competition with their users/owners by developing into global custodians or be engaging in other commercial activities?

My first duty is to thank UBS, Dresdner, Deutsche and the many other sponsors and organizers of ISSA in general, and my old friend John Gubert in particular, for inviting me to join this extremely distinguished group of leaders of our industry. It is not often that a journalist gets to keep respectable company – especially in such exquisite surroundings.

Who knows? If the invitations keep flowing, I may yet become a fully house-trained member of the human race. But judging by my recent e-mail in-box, there is some way to go yet.

One of my angrier correspondents described me in a recent e-mail as “unfair and irresponsible,” and having a “penchant for paranoia and controversy.” Happily, these are the ideal personal qualities to bring to bear on the subject before us today. For no topic of discussion in our industry today is more replete with paranoia and controversy, or more crowded with unfair and irresponsible claims and counter-claims, than this question.

I refer of course to the title of this session. Which I have – no doubt unfairly and irresponsibly – abbreviated to: “Should depositories be allowed to compete with custodian banks?”

The short answer to this question is: “Yes.” But since ISSA has asked me to speak for twenty minutes, I will give you the long answer as well. It is: “Yes, but.”

Let me explain:

None of us likes it, and whenever we encounter it, we do our best to avoid it. But the truth is that competition is, always and everywhere, a good thing.

- Competition prevents established providers from over-charging and under-serving their customers.
- Competition forces established providers as well as new entrants to a market to innovate - in terms of technology, in terms of service, and in terms of seeking out and servicing entirely new groups of customers.
- And – and this is often forgotten - it is competition between *customers*, as they search for a competitive advantage of their own, which forces service providers to keep prices low, service levels high, and rates of innovation up.
- And there is another form of competition which is often forgotten too: competition for *capital*. It is competition for capital which ensures that good providers and good projects get funded, while bad providers and bad projects do not. Competition for capital is the vital financial discipline on which capitalism – in all its forms – ultimately depends.
- Last but not least, it is competition – in all its forms - which keeps the dead hands of the regulators off our industry. For where markets are open, the barriers to entry are low, and there is a genuine contest between providers for customers, regulators have no locus.

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These points seem to me to be self-evident, utterly non-contentious, and to describe a commercial ideal to which even the most unreconstructed paranoiacs and controversialists can subscribe with a clean conscience.

But *ideal* is the operative word. For the securities settlement infrastructure of western Europe today can scarcely be described as a hotbed of competition. There is virtually no competition between providers to settle transactions.

Take the equity markets. They are the exclusive preserve of national CSDs and agent banks, irrespective of whether a transaction originates at home or from abroad.

The bond markets? The biggest – Italy – remains entirely a domestic monopoly – and now looks set to become even more of one.

So is the UK gilt market.

True, the ICSDs have captured a share of the business in some government bond markets. But the Euromarkets remain their duopoly. And can any of us truthfully say that ICSDs, CSDs, global custodians and agent banks are fighting fiercely for the same customers? I don't think so. The global custodians own the fund managers. The agent banks own the CSDs. The global custodians own the agent banks. And the global custodians and the ICSDs carve up between them the business of the major broker-dealers, in ways which cannot rightly be described as competitive.

(This partly explains, incidentally, why the global custodians are such uncritical admirers of a Euroclear-led realignment of Europe on the horizontal plane – but that, I suspect, is a topic we exhausted yesterday.)

The truth is that the only real competition for customers in any part of the European infrastructure occurs between the ICSDs and the agent banks. Even this is of recent provenance, and partial effect. After all, ICSDs are still using agent banks even where they own the local CSD, let alone have a direct link to it.

Lastly, there is not much competition in service provision either. I looked the other day at a study of the services provided by 18 of the CSDs and ICSDs of western Europe:

- 13 out of 18 provide securities lending services.
- 12 out of 18 provide paying agency services.
- 11 out of 18 provide stock registration services.
- 8 out of 18 provide proxy voting services.

Again, this might be thought to be conclusive evidence that CSDs and ICSDs are straying into the territory which was once the preserve of the custodian banks: namely, asset-servicing. But in most cases the competition is more apparent than real.

Are the securities lending operations of the CSDs competing with custodians to feed the prime brokers and the proprietary trading arms of the investment banks? I don't think so.

In whole areas of business there is no competition between depositories and banks at all. Fund accounting and transfer agency are untouched by depositories. Most depositories are in no position at all to compete with the agent banks to supply banking services.

Yes, the ICSDs are. But the prices they charge for cash management and credit scarcely suggest that they are locked in a fight to the death with their competitors at the custodian banks.

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So if we believe that competition is the key to efficiency and innovation, we can scarcely be surprised that the clearing and settlement infrastructure of Europe is neither efficient nor innovative.

That statement must of course be qualified to the extent that the inefficiencies occur largely across borders rather than within them.

There is no need to bore ourselves with yet another recital of the reasons why that is the case, or to rehearse a litany of the many legal, regulatory and fiscal barriers to efficient cross-border clearing and settlement in Europe. Even if we felt the inclination, it would be quite pointless: since there is virtually nothing that any of us can do either to mitigate them or to eliminate them. By my reckoning, only two of the sixteen barriers to efficient cross-border clearing and settlement in Europe identified by the Giovannini Group are amenable to alteration by market participants alone.

But one important thing which is alterable by us, and it is this: the ownership and governance of CSDs and ICSDs. If we genuinely want to encourage competition in clearing and settlement in western Europe, we have to abandon our customary ways of thinking about these tasks. We have to abandon the idea that clearing and settlement are the financial services industry's equivalent of cleaning the sewers. A dirty task. A job for a public utility.

Any leader of a CSD or an ICSD who portrays the clearing and settlement of securities in this way – as a public utility – may not yet be telling a lie. But he (or she) is certainly beginning to live a lie. Today, CSDs and ICSDs masquerade as public utilities. But they are behaving as commercial companies. They compete directly with the agent banks along an expanding length of the value chain. They have to.

It is no coincidence that the readjustments of the pricing schedules of the depositories has coincided with the rise of the netting engines. With fewer transactions proceeding to settlement, the depositories have no choice but to find other ways of earning a living.

It may be mutual funds, or insurance policies, or corporate actions, or proxy voting, or collateral management, or virtual matching. But let there be no mistake; clearing and settlement in Europe is set not on a course of convergence, but on a course of collision.

The logic of the strategy of the depositories, currently being pursued by means of mergers and links, must end in the disintermediation of the agent banks.

- Dressing up this strategy as *pro bon publico*.
- Calling dividends to shareholders “rebates” and “price cuts.”
- Portraying the management of the depositories as latter-day philosopher-kings, cutting through vested interests to give European investors what they need.

All this is nonsense. And it is increasingly intolerable nonsense, not least because the depositories are competing directly with some of their own shareholders.

I say it is intolerable because, so long as that is the case, the freedom of the depositories to compete – to compete wholeheartedly with the custodian banks – will be constrained. It follows that they must become commercial companies in name as well as in fact. That is what I meant when I appended the word “But” to the word “Yes” in my opening remarks.

The depositories must cease to be a privileged caste. They must incorporate and float; they must compete openly with the banks for capital; they must invest that capital at their own risk; they must seek to win customers not by operating monopolies, but by supplying competitive, innovative, high quality products and services at prices customers are prepared to pay – right across the full range of securities services.

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Consider the advantages:

- Capital can be raised from outside the industry.
- Shareholders, not users, will pick up the costs of investment.
- Users will pay only for what they use.
- Finance, revenues, costs, prices – they will all be far more transparent.
- Progress will not wait upon consensus.
- Banks will be free to buy depositories, and depositories free to buy banks.
- Managers of depositories will decide, not dissemble.

For no claim is more hollow than the one we hear from user-owned and user-governed CSDs and ICSDs: that they are doing only what their users want. What do they think commercial providers are doing? Something their users don't want? The truth is that user-owned, user-governed entities are more liable, not less liable, to embark on agendas drawn up by their managers rather than their customers.

The only way properly to align the interests of managers and shareholders is by the creation of a genuine market in corporate control, not through the genuine anti-market of user ownership and governance.

Already, we have seen depositories restrict membership: in particular, by excluding investors from direct membership. In the guise of acting *on* behalf of the common good – whatever that is - they are set free to pursue strategies designed to perpetuate their own existence; eliminate the threat of competition; fix prices in perpetuity; and embark on prestige projects of limited economic value.

If we want to revert to the way in which the average European stock exchange worked until they were demutualized, if we want to mimic the way those other user-owned and user-governed public utilities have worked: SWIFT, CLS, GSTPA. Fine.

But if we want change and dynamism – if we want the optimum solution for clearing and settlement in western Europe – we must take our chances on depositories driven not by their conception of the public interest but by that sternest of taskmasters: short-term shareholder value.

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Already I can hear the chorus of execration: How is it possible to believe such a thing? Do we not know that clearing and settlement are no ordinary monopolies? - They are far worse than that: they are natural monopolies.

My response is simple: do not believe it! There is no physical or technical obstacle which will make it inefficient for more than one provider to supply clearing and settlement services in every securities market. Computer technology was never so cheap - or so powerful. Bandwidth is so cheap and plentiful that most of the suppliers, if they have stayed in business at all, cannot even give it away. All of us know this. Which is why the natural monopolists have come up with a new argument: the “network externality.”

In other words, the benefits of everybody settling at the same CSD in the same way are so great that a monopoly will arise naturally – just as it did with VHS technology or Microsoft Windows.

Well, the only network I can see operating here is that between the European politicians and bureaucrats, and the rent-seeking would-be monopolists at certain depositories, who would

have us believe that an integrated European capital market depends on a single CSD, a single CCP and a single European stock exchange. And the only externality I can see is that most bogus of off-the-shelf political arguments: the need for “Europe” (whatever that is) to compete with “America” (whatever that is). The irony of all this is that those who are most vociferous about the need for consolidation of CSDs are also the most vociferous about the need for competition at the trading level.

Yet trading is far more likely to be a natural monopoly than settlement: order flow attracts order flow; liquidity attracts liquidity – that is a true “network externality.” If you don’t believe that, just ask our Swiss hosts about what is happening at virt-X.

The same is almost certainly true of clearing: the benefits of netting and cross-collateralisation through a single counter-party may indeed be so great that clearing is a natural monopoly. But not settlement.

After all, what is settlement but the receipt of securities and the delivery of cash? Does it really matter if the accounts where buyers receive securities and sellers receive cash are in the same place? I don’t think so. They aren’t now. And nor do buyers and sellers in any other industry think they need one bank to take the money and one warehouse to receive the goods.

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But, look - people will say - that is all very well in theory. But look at the grim reality of cross-border securities clearing and settlement in Europe today. Europe certainly looks inefficient. In the European Union alone we have 19 CSDs and two ICSDs providing various types of services. There are two more CSDs outside the Union looking to get in: SIS SegalInterSettle and the DTCC. These organizations have a wide variety of ownership and governance structures. Some of them are linked to exchanges, some have integrated CCPs. The scope for cross-subsidy is rife.

In most markets we also have least two agent banks acting as gatekeepers to the local CSD, and sometimes more. Which is why we have ended up with five different ways to settle securities across borders in Europe:

- First, by direct access to a CSD
- Secondly, by using a local agent bank
- Thirdly, by using an ICSD
- Fourthly, by using a global custodian
- Fifthly, by accessing the bi-lateral links between CSDs via your local CSD.

It seems messy. It feels expensive. And if something looks and feels messy and expensive, why not force all the providers to come together in a mutual or co-operative structure, and produce only what is needed at regulated prices?

The present system is obviously wasteful. It has led and will lead to the duplication of securities processing platforms. Users are obliged to maintain dozens of interfaces in the back office. And we all know that the only people making money out of all this inefficiency are the agent banks. Indeed, it seems to be axiomatic in our industry that agent banks do nothing except make money out of inefficiency.

So why don’t we just get rid of them, and the national CSDs which keep them in business, and have a single CSD and a single CCP – and probably a single stock exchange as well for that matter? I’ll tell you why not. Waste, duplication, inefficiency: they are not signs that a market is failing. On the contrary, they are signs that a market is working well.

Think how much duplication there is between Mövenpick and Novotel, or between Tesco and Sainsbury, or between JP Morgan and State Street. Think how much money they waste on proprietary space, proprietary technology, proprietary distribution networks - and pointless advertising. But is anybody seriously suggesting that hotel and supermarket and custody products be produced by compulsory partnerships in a standardized way? Of course not.

Competition between near-identical providers is extremely fierce precisely because the products and services are nearly identical.

The cost of switching from Novotel to Movenpick, or from Tesco to Sainsbury's, or from Benson and Hedges to Marlboro, or from Pepsi to Coke, or from Persil to Ariel – if not from JP Morgan to State Street - is as close to zero as makes no difference. So these businesses have to work harder to win our business, and to retain our business. They have to differentiate themselves: above all, they have to differentiate themselves by innovation. It is precisely where providers are competing head to head, where they are running neck and neck, that innovation is most likely to occur.

Where competition is absent, there is no incentive to innovate.

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Competition. What a funny little word it is. How we worship it in theory, yet deplore it in reality. We do that because competition is so powerful that it threatens us, and makes us fearful.

Yet competition is something which is only just beginning to happen in European securities clearing and settlement. If Europe is inefficient, it is not because it has too much duplication. It is because it has too little competition. So let's not snuff it out before it has got going. And let's not snuff it out because we like choices, or think it will lower prices, or because it will prompt exciting innovations - though it will provide all of those things. Let's not snuff it out because competition between alternative providers in a free and open marketplace is not a luxury. It is the only way – the only way – we can ever find out what is the best future for clearing and settlement in Europe. I say the only way because we hear a lot about what a fantastic job the DTCC has done for settlement efficiency in the United States. And how we should copy their example. In other words, we think we know the optimum solution already.

But consider this: All we know about clearing and settlement in America is what the DTCC has done. We don't know what it hasn't done. We don't know what its competitors might have done, had they survived. Or – and this is in many ways far more important – we don't know what its competitors might have done had they been allowed to emerge. By choosing the DTCC alone, the American securities markets cut themselves off from a whole range of possibilities. Solutions, innovations, ideas which - had they come into being - might have made the DTCC not a paragon, but a laughing stock.

Now, if we meld our CSDs together and eliminate the agent banks of Europe we will achieve precisely the same thing: we too will cut off an infinite variety of possibilities.

Competitive markets are not something we choose only when we do not know better. They are places where we discover what we do not know. Where we discover what works, and what does not work. Where we keep what works, and jettison what fails.

That is why markets are wasteful. That is why they duplicate things. That is why they are *inefficient*. Because they have to be, if they are to work at all.

So when we read the former executive director of the European Securities Forum telling us that "very few of us in the financial sector have a strong enough unselfish gene to sacrifice our own short-term interest for some one else's long-term one, we should remember that it is the genius of the market to fashion great public goods out of the most base and selfish of

motives. The truth is that Pen Kent does not know what the long-term interest of the securities markets is. None of us do. The knowledge we need to know is known only to the markets themselves.

So if you think agent banks are costly intermediaries, think again: they may actually be providing a service which is valuable.

If you think five different ways to settle across borders in Europe is four too many, think again: different participants need different services. Some want speed; some finance; some settlement; some custody; some regions; some countries.

So if you think the CCPs that are popping up everywhere now are wasteful and inefficient, think again: they may be an honest attempt to discover a need which is as yet unknown, let alone unmet. For we don't know what we want, or what we need, until the possibilities are put before us. As a result, we cannot possibly know in advance where we want to end up. Nor do we know how things – technology, legislation, rules - are going to change. Nor do we know how changes in any one area might cause changes in another area. Markets are unstable, dynamic, inconstant, fluid, spontaneous, infuriating. But they are far, far better than any map of the future which we can draw for ourselves.

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The other day I read in the *Financial Times* a quotation from Werner Seifert. He was complaining that the consolidation process in Europe was like playing chess in the fog. "Some parts of the board are covered in fog," he said. "When one piece moves, others move too. No one is quite sure of the rules. Sometimes it is not even clear whether we are playing chess or Monopoly."

Well, Werner, welcome to capitalism: that's how it works. Every single one of us is in a cloud of fog, moving pieces in directions we cannot determine, with consequences we cannot predict.

The fondness of some of us for competition in clearing and settlement in Europe is therefore a measure not of unfairness and irresponsibility, still less a measure of our paranoia or our penchant for controversy. It is not even a measure of our arrogance. It is a measure of our humility in the face of the vastness of our ignorance. It may be that we can dispense with depositories altogether. It may be that agent banks can coalesce and obviate the need for them. It may be that banks can "internalise" settlement traffic which currently passes through the depositories so successfully that utilities are redundant.

Think it possible: new intermediaries may arise, out of left field, to trade volume for price. All we know is that we don't know. I don't know; you don't know; we don't know; it is, quite literally, impossible to know. All that matters is that we keep the possibilities alive.