

In the second part of our session, 'Looking inside – impact on economics,' we are going to look at the impact of the financial crisis and its aftermath on custodians and the market infrastructure.

We are joined by Michel Laurent and Derrick Fung. But I have asked Marc van den Berg and Danny Sullivan to stay with us, because I think all points on the value chain have something to contribute to this discussion.

I thought I would begin with a few observations of my own to set the scene.

Frankly – it is difficult to be optimistic about the future of the custodian banks.

One custodian I spoke to recently told me he thought, in effect, that it was all over for the custody industry. There was no respect any more, he said, for the value of credit intermediation. All that they did was being 'de-risked' in CCPs. Clearing and settlement margins were being squeezed to levels only a utility, not shareholders, could live with. Regulators wanted to pin on to the custodian responsibility for every conceivable risk incurred by investors – sub-custody risk, infrastructure risk, depository risk, valuation risk. Custodians cannot do all this, he said: they are going to have to start refusing business.

But it gets worse.

The big winners from the financial crisis were not the custodian banks. It was the market infrastructure entities – especially the CCPs. They played a blinder after Lehman. Equally, they have enabled equity trading start-ups to seize 25-30% market share in some equity markets. Now regulators want to see them in OTC derivatives and securities lending as well. That is not good for banking intermediaries.

But it gets even worse. And not just because everyone now hates banks on principle.

Over the last 20 years, custody has evolved a highly risky business model. This was to give away the core product – safekeeping – to get hold of the assets. And then get paid by exploiting those assets.

By under-paying their clients on cash. And over-charging them on FX. And lending the securities on unfavourable revenue-splitting arrangements to prime brokers, who then added a fat margin before on-lending them to hedge funds.

The last year has shown how vulnerable this model is to low interest rates and lower equity and currency market volatility and valuations. Securities lending revenues in particular have fallen off a cliff.

The question is whether plunging securities lending, FX and net interest margin revenues are cyclical or secular. Of course, there is a heavily cyclical component, but I think some things have changed permanently.

Custodians are already having to improve the quality, and lower the yield, on their own short term investment portfolios.

Clients do not want to leave all their cash with a single bank. They may even start to appoint third party cash managers. Cash collateral reinvestment has acquired a stigma it may not lose for a generation.

As for FX, even if it recovers, the pressure from greater transparency on rates achieved is now irresistible. And transparency, if it means anything, means lower spreads.

As for securities lending, I mentioned earlier this morning the problem of the disappearing (and increasingly unpopular) short sales. Think how many different types of securities transactions depend on short selling:

- Creating a long/short portfolio of any kind needs shorting
- Buying a convertible and shorting the underlying equity needs shorting
- Buying the target company and selling the buyer in a merger transaction needs shorting
- Buying an index future, and shorting a basket of stocks needs shorting
- Hedging an options position needs shorting
- Hedging market risk in a portfolio needs shorting

All of these standard transactions we all grew up on, depend on shorting – and shorting is getting harder to do. Issuers don't like it. Regulators are obliged to dislike it. Beneficial owners are reluctant to support it. Even where they continue to do it, they will want more of the return and less of the risk.

And then there is the prospect of everything in securities lending but specials moving on to electronic trading platforms backed by CCPs. That solves the problem of risk, or at least transfers it to the CCPs – which is another win for them. This is happening already. So I think the golden age of securities lending is over. And what has happened in the European equity markets offers us a foretaste of what might now happen in securities lending.

Christoph Schenk said yesterday that he thought the growing trend towards high frequency and algorithmic trading would greatly increase the volume of securities transactions. That is almost certainly true – indeed, we see it already in higher volumes and lower values per transaction. That sounds like good news for the custodian banks that settle those transactions. But there are a number of reasons to think that it might not be.

One is that custodians will have to invest in infrastructure to support transaction volumes they hardly ever see, even on a good day, just in case, and indeed may never actually see – but they have to make the investment anyway.

The second thing is that most of those trades are going to be netted through a CCP: neither the custodian, nor the CSD is going to see them at all – unless they start netting themselves, through internalization, which will interest the regulators (and they are interested enough already).

The third thing is that the increased volumes from high frequency trading will be offset by a decline in transactional activity by prop trading desks and hedge funds – as short selling, and the leverage and securities lending that support them, become more expensive to obtain.

There is another problem: If broker-dealers want anything from their custodians right now, it is lower costs.

They are watching, as Don Donahue pointed out yesterday, millions of buy and sell orders flashing through front office systems in the blink of an eye. They are wondering why millions of settlement transactions are not flashing through back office systems in the blink of an eye as well. They know that MTFs have drastically cut the cost of trading equities. Why is the cost of settling equities still so high? Most major broker-dealers have already outsourced large parts of their back office to India. They are asking themselves

why custodians – and, more particularly, why CSDs and ICSDs – have not followed their example more closely.

Well, one reason the cost of clearing and settling trades remains so high is that custodians are still advancing an awful lot of credit to oil the wheels of clearing and settlement.

Generally speaking, custodians still pay in the morning. And get paid in the evening.

The regulators know about that, and a working party of the Federal Reserve is indeed already working on how to solve it in the US tri-party market.

It cannot be long before the custodians, let alone the regulators, conclude that the game is not worth the candle and say, 'Let's put all this risk into a public utility.'

And the CSDs, who thought it might be all over for them after T2S was announced, are getting ready to fulfill exactly that role.

On one reading, Greater Euroclear and LinkUp Markets are the DTCC for Europe in embryo.

The broker-dealers have got there already. In the US, the DTCC fulfils for them already the role of public utility. In Europe, once T2S is in place, most broker-dealers will opt for self-clearing in most European equity markets. So, less obviously, will most global custodians: with T2S, they will be able to self-clear and self-settle in Europe just as they do already in the US.

Once inter-operability between CCPs is agreed, the custodian banks stand to lose even the new role they have created for themselves in Europe – as third party clearers and collateral managers to sell- and buy-side firms active on multiple, disconnected MTFs.

No wonder sub-custodian banks are already starting to compete with their clients for the same business. And the global custodians are tilting not only at the domestic institutional business of their sub-custodians, but actually going directly for their sub-custody business. After all, both sides have nowhere else to go.

The distinction between the sub-custodian bank and the global custodian bank is increasingly meaningless. No one respects the boundaries any more. Global custodians and sub-custodians, squeezed from the top by clients and from the bottom by market infrastructures, are locked in a war to the death. It will likely end with just three or four contenders, each of them, to coin a phrase, "too big to fail," and a bunch of infrastructural entities.

As you know, I have argued always for the preservation of competition, and of variety in this industry. But I am beginning to give way to despair. I hope you will forgive me for sometimes thinking, 'Thank God I have sold Global Custodian magazine.'

Now, I would like to invite Michel to give us the optimistic case.