



27 April 2001

## **Capital Markets Without Borders**

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### **“What Drives the Market”**

#### **1. Introduction**

The market for capital in Europe is driven, as it is everywhere by a combination of the fundamentals of supply and demand; by competition; and by historical market structures. But of course there are many conflicting cross currents of self-interest, which impede the efficiency of the market. In some cases these are strong enough to threaten a “market failure”. If they are not remedied, there is a risk that the ‘pan-European Capital Market’, or at least the wholesale part of it will relocate outside Europe. We would then all be the losers. Today I want to discuss these factors, in particular the questions of cost and competition, because the evidence of these reveals the tensions.

I could throw the statistics at you and I would of course choose those calculated to support my thesis. Alas I do not at present have the research resources to muster them so I have to rely on your own knowledge to test assertions.

#### **2. The Fundamentals**

By these I mean of course the supply of capital and the demand for it – arguably the real “users”. All the rest of us are intermediaries, service providers, or whatever.

#### **3. Supply**

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The UK and the Netherlands already have well-developed collective savings institutions, large as a proportion of GDP. The ageing population of Europe and the inability, or unwillingness of governments to provide adequate pensions will lead everywhere in Europe

to a massive growth of collective savings. Institutional investors will compete with each other for this potential savings mountain both by lowering management costs and by investment performances. The managers will be tested in the performance tables. They will be driven by those tests to diversify their portfolios in search of the most promising assets. Where these are denominated in the Euro, managers will not be deterred by distorting factors like national frontiers, regulatory regimes or costly national clearing and settlement monopolies, provided they have sufficient market freedom. And where they do not have that freedom they will exert collective pressure to get it. In those countries where they fail to do so they will reduce their activity. Local markets, which seek to retain liquidity and transaction volume by protectionist behaviour, will perversely end up losing it. The institutional investors will command liquid resources and will take it where it most suits them. By growth or merger they will become genuinely pan-European – indeed some already are. They may in this respect be ahead of the structure of the market.

The Wise Men in their Interim report last November have stated that the yield on European pension portfolios in countries with severe investment restrictions was some 4% lower than that in the USA. The pressure to close that gap will be relentless.

I must at some point make an important caveat. It fits here as well as anywhere. There will of course continue to be local markets for local savers and local users of capital. I am mainly talking today about the pan-European, wholesale markets, not the retail ones, which will remain important. "Local" may mean either at the national level or smaller territories. It could even mean very specialist, niche markets. But important though they are, especially for small and medium size enterprises which are major job creators, their existence is not an excuse for denying the emergence of the wholesale market.

### 4. Demand

And now for the issuers. Some European corporations are outgrowing the capacity of their national markets to meet their capital needs. This accelerates the trend for them to raise capital elsewhere and in the process to internationalise their ownership. Could we have a situation where the top 100 European investors had to keep their holdings in the top 100 European companies in their foreign portfolios because they were denominated in dollars and quoted elsewhere?

### 5. Historical Market Structures

Markets have historically been physical places concentrating supply and demand and so providing relatively efficient price discovery. For a long time our capital markets have been physical. Indeed it took the intervention of the Group of Thirty at the end of 1980s to kick-start global dematerialization, and the process is not yet complete. Physical market places were often granted local monopolies and it was convenient and logical for them to provide post trade services. They have been labelled "vertical silos", and typically the top of the silo, that is the trading platform, calls the shots down to the bottom.

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But technology has changed the range of possibilities, and the original logic and convenience have become anti-competitive ways of keeping transaction costs unnecessarily high. The ESF has proposed as a first step the removal of obstacles so that clearers or settlers in the EU could obtain a home passport to provide competitive services to transactors at present locked in a silo. The Commission seems to be contemplating another approach requiring the vertical silos to allow transactors to enter them at any floor so to speak. But neither solution is complete and probably would not on its own pass the efficiency test which the European Capital Market must pass – i.e. internationally competitive costs across Europe which match or beat the best elsewhere. I recognise of course that some European transactions are cheap – basically those in some domestic markets. But there seems no doubt that seeking to operate in Europe as though it were a virtual, single capital market involves unacceptable costs. Much of that cost flows from sheer complexity – the need to understand and conform to more than a dozen regulatory systems; the need to tool up to interface with dozens of trading platforms, clearers, settlers and depositories; the need to finance all their capital expenditure and multiple overheads.

You have heard the guesstimates of some these costs – 6 times more costly than the USA? 10 times more? a billion dollars or Euros to be saved a year. I do not have more scientific numbers than that – but you all know that the real ones are too high!

Some of the possible solutions look superficially attractive – making all the service providers open up to all comers – but that would or could lead to yet more complexity. Let me remind you of the study made of the options in the USA before the SEC actively promoted a settlement monopoly. Interlinking all seven clearing houses would have saved under 10%; consolidation to three interlinked exchanges would have saved 33%; and a move to a single monopoly would save 64%. Given evidence of that kind the argument for consolidation on cost grounds looks overwhelming. This observation underpins the entire ESF campaign.

But what will happen if consolidation is frustrated and the cost of using existing service providers remains too high? Will the status quo remain unchallenged, thus allowing local monopolies to maintain high fees and pass them on to captive end users? Would there in other words be an unholy alliance between service providers and intermediaries to defend Europe's inefficiencies? The answer to that question could be "yes" – but I do not believe it will be.

Look at the pressure of official opinion. In their February report the Wise Men stated "*if it emerged that the private sector was unable to deliver an efficient pan-European clearing and settlement system for the European Union, a clear public policy orientation would be needed to move forward*". Look also at the pressure on costs in the financial industry – especially in response to the recent downturn in earnings. Institutions, which fail to control cost, go out of business, or get taken over. Or at least they do in a free market place. Why then not leave it all to the market? Quite simply because there are too many barriers – "market failures" if you like. But that does not mean the market will not react. It is doing so already. The users are trying to capture, either in-house or by dedicated outsourcing, as much of the clearing and settlement process as they can in order to get costs down and reduce the transaction flow to the service providers – and they are beginning to argue more strongly for interoperability which means more flexibility and more choice. Can you blame them? But do you believe this is the best, the second best or any kind of best solution for Europe? I personally do not.

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I still hold firmly to the view that rational, horizontal consolidation of service providers is the outcome which would best serve the fundamentals.

Before I talk finally about the regulatory and competitive issues that would arise from that, let me dispose of another “second best” solution that some are advocating – one, two or just possibly three mega silos. Suppose the major stock exchanges in Europe had a further round of consolidation and created effectively a single pan-European stock exchange offering straight-through clearing and settlement. Would market users object to that? I am sure it would produce some real efficiency gains. It could have a coherent and co-ordinated governance of strategic direction, technical efficiency and containment of costs. But there would be some serious concerns.

First it would probably be anti-competitive. We all used to believe that the trading platform in each market was a natural monopoly. We no longer do. Indeed the ESF supports diversity in trading in the belief that this does not overall add to costs, nor lead to an unacceptable fragmentation of liquidity because of the efficiency of arbitrage and technology. I accept that the arguments are not all one way. But would you be confident that alternative ESNs or ATSS would have access to the clearing and settlement system in a silo on equal terms?

And there is another difficulty. Stock exchanges are losing their mutual, user-run status. I support that and do not want to turn back the clock. But would you be happy if a commercial organisation, whose ownership may have little identity of interest with the rest of the market, had control and direction of clearing and settlement for a mega silo? The volume of the risk to be managed would be huge, and the exposure to those risks would ultimately fall on market users and investors. The regulators have yet, as I understand it, to come to a conclusion on the issue of competition versus monopoly for clearing and settlement, but I suggest that ownership and governance would necessarily be among the important factors to evaluate.

Most of you by now have probably heard the ESF argument for a horizontal model. That is for diversity in trading; user owned monopoly for clearing; and something similar for settlement. Its virtues are essentially pragmatic. We argue for competition at one level but monopoly at another. Many who are familiar with the model are nevertheless uncomfortable with the monopoly aspect. In the last few decades we have all come generally to distrust monopolies. Why should this one be any different?

The argument in favour of a monopoly in this case relates mainly to standardisation, economies of scale and efficiency. The monopoly would admittedly manage a huge volume of risk – and it would be concentrated. Of course such risk would have to be underpinned by margins, capital, collateral or other default mechanisms, but the portfolio effect of combining equities, futures, bonds, and OTC would I believe save very large, perhaps, huge, amounts of capital which would otherwise have to be kept for that purpose in separate boxes in an inefficient, fragmented structure.

One of the ways of guarding against abuse is an ownership and governance structure, which necessarily aligns the interests of ownership with prudence and investor protection. The ESF argues that user ownership with cost-based tariffs would create such an alignment of interest – although the regulators would also have to be satisfied that the constitution of such an organisation had appropriate safeguards.

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Regulators remain concerned about the concentration of risk. They have asked ESF to help them define and measure this risk. What they are asking, I believe, is whether there is an optimum concentration of risk below which efficiency is lost and above which the risk is unacceptable. Let us have no doubt that at present virtually all the risk in each national vertical silo is already concentrated – although, it is true, not yet for all classes of product together. I am not aware that the US regulators are concerned that the DTCC concentrates unacceptable risk – although I do know that the monetary authorities in some jurisdictions have been encouraging the creation of netting, clearing and settlement systems for forex transactions. This must surely be in the belief that an organised, common infrastructure brings greater certainty of execution and superior risk management. Such an infrastructure also provides a unique regulators' eye view of potential stresses and strains. Without such a view, it is hard for regulators to be confident that no critical mass of unacceptable risk is lurking in the sum of the parts they cannot see.

By the way I do not accept that monopolies always go to sleep at the wheel; cannot innovate; and cannot accumulate sufficient capital to finance necessary technology. I do accept that such a monopoly should however be contestable. How could that be? One possibility would be for major continental systems to provide back-up for each other and the seeds of a possible challenge. Contestability, which was virtually an empty threat, would not suffice.

I have the impression that some people assume that a monopoly is a kind of parastatal organisation, protected by law, and implicitly underwritten by the taxpayer. What ESF is proposing would be none of those and it would be wrong for it to be so.

In short I am arguing that there now exists in Europe some anti-competitive local monopolies which extract super-normal profits and at the pan-European level constitute a market failure. A horizontal restructuring would create a natural monopoly for clearing which would not share those unacceptable features and would have built-in safeguards against them.

Of course such a model would drastically affect the transaction flow to settlers and CSDs and either drive up their unit cost or drive them out of business. Some of the settlers are rationally reacting to that prospect by proposing that they take on the role of "trade concentrators" in the post trade environment, i.e. moving up the food chain to be alongside the clearing risk manager. I have no difficulty with this concept, provided that the ownership and governance structure, which I advocate for a utility model, is adopted by them. Indeed I suspect that when the settlement cycles of all our security markets come down to, say, T + 1, the argument for merging clearing and settlement into a single, pan-European natural monopoly would become very strong. The US have provided a working and largely successful model which is still evolving towards more consolidation. Their wheel works pretty well. Let us not agonise with square or triangular ones when we know a round one gives you the smoothest travel.

I am frequently asked if the current round of IPOs is reinforcing the vertical silos and making the horizontal model redundant or unobtainable. I answer "No". If anything the argument for the ESF model grows stronger. Can the ESF and other interested parties break the logjam to get there? I intend to do my best to make that happen. If I fail the European capital market will be the loser – and so will our economies, our families and our prosperity.

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