Dominic Hobson talks to Jeffrey Tessler

Markets are accidental, not deliberate

The financial crisis ended a sterile debate about the ownership and architecture of market infrastructures in Europe. It also transformed assessments of their value, in terms of containing the costs of capital, collateral and post-trade operations. Jeffrey Tessler, chief executive officer of Clearstream, argues that European infrastructure is now poised to deliver the ideal combination of competition and consolidation.

The acute phase of the great financial crisis in 2007-08 was immensely destructive, but not everything it destroyed was worth keeping. Among the material lost, and which posterity will not miss, is a sterile debate about the structure and ownership of financial market infrastructures. The years immediately prior to the crisis were dominated by a dispute between the Horizontalist school of infrastructure (which held that trading, clearing and settlement services must not be provided by the same organisation) and its Verticalist opponents (who argued that organisations which cleared and settled the trades they hosted were more efficient). A related debate, between those who believed that market infrastructures should never be privately owned or for-profit, but should always be user-owned and user-governed was even more animated.

By concentrating the minds of the leaders of the securities industry on more urgent matters, the crisis closed down both of these debates. "You do not hear discussions any more about horizontal versus vertical, or user-owned and user-governed versus privately owned and for-profit," says Jeffrey Tessler, chief executive of Clearstream and a member of the executive board of Deutsche Börse. "Since the financial crisis, what people care about is whether you have the products and services to help them manage their risks and control their costs. The crisis was a Eureka moment. For the first time, the market understood the value of an integrated infrastructure, with trading and banking as well as clearing and settlement capabilities at time when confidence in the banking sector was low. The crisis vindicated the Deutsche Börse Group model of integrated trading, clearing, settlement and banking."

The most obvious sign of this was a surge in cash deposits at Clearstream Banking, which rose by 14 per cent from €5.6 billion in 2007 to €6.4 billion in 2009. This reflected confidence in Clearstream not just as a bank, but as a market infrastructure. The rapid growth in the funding provided by the Euro GC Pooling service, delivered via a combination of the Eurex central counterparty clearing house (CCP) and the Clearstream collateral management service, was an even more significant indicator of the value a vertically integrated infrastructure can add to a market under duress. In 2008, daily volumes outstanding peaked at €61.4 billion, nearly twice the highest value seen a year before, as banks recognised that the service eliminated counterparty credit risk through a combination of intermediation by a central counterparty clearing house (CCPs) and the acceptance of collateral eligible at the European Central Bank (ECB) only.

> "Since the financial crisis, what people care about is whether you have the products and services to help them manage their risks and control their costs. The crisis was a Eureka moment."
>
> Jeffrey Tessler

A measure of confidence has since returned to the banking sector, but the value of the services provided by Clearstream has not diminished. In fact, they have increased. A wider collateral management platform, the Global Liquidity Hub, is now linked to trading platforms, CCPs, central securities depositories (CSDs) and sub-custodian banks all over the world, enabling banks to mobilise collateral for financing and collateralisation purposes on a global scale. Eurex Clearing has added to this service a set of sophisticated collateral segregation and optimisation services that enable banks to extract maximum value for their collateral while reducing the risk. "We spent the years after the crisis convinced we had the right model, and asking ourselves how we were going to develop it, especially in a changing regulatory environment," explains Tessler. "Financial institutions of all kinds that used our services for the first time in the crisis are now using them to make savings on capital and collateral."

The savings stem from a variety of sources. Pooling collateral through the Global Liquidity Hub lowers the cost of raising collateralised finance, and reduces the cost and consumption of collateral in settlement and securities lending and financing activities. Shifting exposures from banks to market infrastructures (including Eurex Clearing) and central banks also lowers capital costs under the Basel III capital adequacy regime. Once the TARGET2-Securities (T2S) single settlement platform for Europe is in place from 2015, the opportunity to net flows of cash and securities through a single account will reduce funding as well as capital costs, and trims operational costs by channelling transactions settled by a global network of custodian banks through a single account as well. In an analysis prepared in conjunction with Oliver Wyman, Clearstream estimated the annual savings available under T2S to a typical broker-dealer at €70 million, a typical global custodian at €50 million, and a typical regional bank at €30 million.

The reason market infrastructures can deliver significant savings of this kind is that they have to act as neutral intermediaries. Despite the fact that Deutsche Börse Group is privately owned and aims to make a profit, it is unlikely to find itself trading against the interests of its clients. This is not only because it is governed by a supervisory board made up of investors and issuers as well as banks, investment banks and brokerage firms, but because its trading, clearing and settlement arms are pure market infrastructures. “We are just a machine for processing trades and transactions,” says Tessler. “There are a few value-added services associated with that processing machine, but you are not going to find an investment banking, asset management or mortgage division here. Unlike a bank, we are never going to be a principal to a trade or transaction. That is a big difference.”

> “T2S creates the opportunity for market participants to manage their cash and collateral through a single account, and that is an opportunity which market infrastructures can embrace and benefit from if they want to.”
>
> Jeffrey Tessler

Retaining the character of a neutral and fully transparent infrastructure requires discipline. The similarities between the services provided by Clearstream and those of a global custodian, for example, are close. They both settle and provide custody for fixed income and equity assets, and work through networks of sub-custodians. “Where competition ends is that we do not go after their clients,” explains Tessler. “Banks are an open field, but providing a pension, mutual or hedge fund or corporate with a global custody service is not where we are or where we are going. Likewise, custodians should not worry that we will use our collateral management capabilities to go after their clients. We do not have reporting, accounting and administration capabilities, and do not plan to invest in them either, so we cannot service much buy-side business. It is important to us to keep our business pure, in terms of the activities we undertake. To retain that purity, we have to be transparent: our clients have to be able to see right through us. I always tell our clients that the reason we have an AA rating is because we are just a processing machine.”

The services Clearstream provides to fund managers offer a searching test of that mechanistic character. The company provides a service that routes orders between mutual fund distributors and managers and, because it settles orders in commercial bank money between accounts held on its own books, it holds units in mutual funds in custody as well. “We have a very specific niche in the funds space, and that niche is where the global custodians do not want to go,” says Tessler. “Order-routing for funds is the equivalent of a stock exchange for stocks and bonds. You are just taking the order from the buyer to the seller. The services that go along with it, such as custody of the units in the fund, is something other CSDs are involved with too.” The service was recently extended to the processing of shares or units in hedge funds as well, with the acquisition of the order processing business of hedge fund administrator Citco. “What we bought is an adjacency to the order-routing we do for long-only funds,” adds Tessler. “The associated custody is exactly the same thing we do already for the mutual funds too. No fund managers have become clients. Our clients are the distributors, just as they are in the mutual fund sector.”

> “We are moving towards consolidation and harmonisation in a competitive environment, which will be much better than a single CSD for Europe.”
>
> Jeffrey Tessler

What drew Clearstream into fund order-routing is the extreme inefficiency of order-processing. That inefficiency has survived because it is a source of revenue for some financial institutions. “Every time you bring efficiency to a market, you are going to upset people,” says Tessler. “When we acquired the Citco business, somebody called me and said, 'We do not like efficiencies. Efficiencies cost us money.' " Attitudes of this kind explain why there is a constituency for more forceful regulatory action to re-order the infrastructure of Europe so that it becomes more like that of the United States, where a single infrastructure dominates the distribution and settlement of mutual funds as well as the clearing and settlement of securities transactions. Jeffrey Tessler is not a member of it. He thinks T2S, the single settlement engine for Europe, will instead spark a series of far-reaching changes. "People think T2S is just about cutting the cost of cross-border settlement, but it is actually a big step towards the elimination of the Giovannini barriers and the creation of a harmonious and coherent market infrastructure for Europe," he says. "It creates the opportunity for market participants to manage their cash and collateral through a single account, and that is an opportunity which market infrastructures can embrace and benefit from if they want to."

Tessler predicts multiple clusters of market infrastructures feeding off a single settlement engine in the shape of T2S, with clients managing their cash and collateral movements throughout the euro-zone out of a single account at a single infrastructure.

Certainly Tessler thinks not every market infrastructure will survive T2S. He expects it to lead to consolidation, but still thinks it would be a mistake to reduce Europe to a single CSD. "Do we want a single CSD for Europe?" he asks. "I do not think so. We are moving towards consolidation and harmonisation in a competitive environment, which will be much better than a single CSD for Europe." His logic is simple: that competition is an even better guarantor of honesty in market infrastructure than transparency. Tessler points out that mandatory price transparency by stock exchanges, CSDs and CCPs under the Code of Conduct for Clearing and Settlement in 2006 did nothing to improve services, little to cut costs, and did not benefit end-investors at all. "We are in fierce competition with our closest competitor," he says. "Our clients have a way out if they do not like what we can offer. Competition forces us to innovate and to deliver a better service to clients. The availability of a competitive choice ought to trump any concern about and whether an infrastructure is privately owned or publicly traded or an user-owned and user-governed entity."

It is a telling observation, because it is a reminder that securities market infrastructures are not natural monopolies. In forms of infrastructure that are natural monopolies – such as roads and sewers and railways – it is difficult to stimulate and sustain competition, but the financial market infrastructure now evolving in Europe does offer the enticing prospect of competition and consolidation. Tessler predicts multiple clusters of market infrastructures feeding off a single settlement engine in the shape of T2S, with clients managing their cash and collateral movements throughout the euro-zone out of a single account at a single infrastructure. "We are proving that we can have a market infrastructure which is efficient and innovative and transparent precisely because it operates in a competitive environment," he says. "In Europe we have found, by accident rather than design, a much better way to run market infrastructures than they have in the United States. It would be a mistake not to recognise that."