Lucio Loubet

9ème série de la Métamorphose n° 48
(73 x 50 cm)

Part II

Infrastructures for global markets

"We have always looked for opportunities in globalisation that can stimulate the growth of our business. We ask ourselves systematically questions such as: can we seize this global opportunity? And, have we got the right strategy and technical wherewithal to do so?"

Pierre Francotte

"It is true that our major focus today is on building and streamlining the infrastructure in Europe, but we continue to see Euroclear as a stepping-stone for non-European institutions investing in Europe and for European firms investing in the rest of the world. Our strategy has always aimed at being a global company and it remains so."

Pierre Francotte

"Being 'global' doesn't mean control, it means cooperation and coordination. In this respect, there is no way an organisation can be 'global' without also being very local; you cannot operate a global organisation from one point!"

Hans van der Velde

"The centre must provide strong leadership to ensure interoperability both of the physical systems and also of the rules and regulations that enforce consistency of consumer experience across the globe, as well as risk management to protect and preserve the system."

Hans van der Velde

"We need to serve our clients global needs, offer them a global service and implement new internal processes to guarantee the quality of execution. So, we have to find a way to operate as a true global firm, even in front of litigation. This cannot be envisioned unless regulatory agencies rethink the ongoing regime that considers audit firms' responsibility as being without limits"

Christian Mouillon

"The tax regime is often discarded when discussing competitiveness, but it has a significant impact. [...] The US extra-territorial vision provides a sizable advantage to American companies."

Christian Mouillon

Conducted by Catherine Distler (PROMETHEE) and Bernard Nivollet (Unisys)

Strategic conversation with

Pierre Francotte

CEO and Chairman of the Management Committee Euroclear SA/NV

Efficient and innovative infrastructures serving global clients

For most companies, globalisation means more intense competition from entrants coming from other countries and the correlated need to go from domestic to international in order to achieve economies of scale. They wonder often whether globalisation is triggering any opportunity. What does globalisation mean for Euroclear Bank whose mission is to facilitate cross-border investments?

Pierre Francotte: From the beginning, Euroclear Bank has been an internationally driven organisation with no specific domestic anchor, distinguishing ourselves in this respect from various national CSDs and banks. We have always looked for opportunities in globalisation that can stimulate the growth of our business. We ask ourselves systematically questions such as: can we seize this global opportunity? And, have we got the right strategy and technical wherewithal to do so?

Internationalisation is more of a challenge for those previously focused on domestic markets, who are only now trying to get into the international field in which Euroclear Bank is one of the incumbents. National stock exchanges and local CSDs have conducted the same analysis and reached the conclusion that global engagement is key.

The market is becoming increasingly global, but how global are your clients?

PF: With about 1500 customers in over 80 countries – investment banks, central banks and other financial intermediaries – a global client base has been a long-standing feature of Euroclear Bank. They operate on every continent, with some specialising in particular regions. Whatever the specific case, they consider Euroclear Bank as the stepping-stone towards the international market. For example, Korean banks acting on behalf of Korean investors will not need Euroclear Bank to invest in Korean securities, but will come to us to hold US treasuries or European bonds and equities. There is an international element in everything that is done in Euroclear Bank.

Globalisation on the client side does not, however, mean that more retail investors will use an institution like Euroclear Bank; I don't anticipate such changes within the next 10 years. Retail investors largely invest in local securities. This phenomenon is partly psychological: people's inherent risk aversion implies a strong home bias. Now, however, they have greater opportunities to acquire securities across borders and will progressively evolve towards more international investment portfolios. Nonetheless, they still rely on intermediaries to access international markets. So Euroclear Bank will remain an institution mainly used by intermediaries. This is different from some national CSDs, like CREST or the Nordic CSDs, in which individuals hold a direct account. But even there, these individuals' accounts are operated by intermediaries.

One key question many industries face is whether the 'global final customer' exists. Are cultural differences narrowing? Are market cultures still different in different parts of the world?

PF: Yes, market cultures were and are different in the US, Asia and Europe, and even within a continent. In the US, an equity culture prevails. Until recently, there was actually little demand by Americans for cross-border investment, as the US market was big enough itself to satisfy these investors' debt and equity investment requirements. Moreover, the risks and obstacles related to foreign investments remained sufficiently large for them to prefer a US-centric portfolio. Some measure of change, of course, will happen, but gradually. This is less a matter of US investors actively looking for greater diversification than because less risky and less expensive instruments will be offered to them. Change will be more supply than demand-driven.

In Asia, an equity culture also prevails and investors prefer their own national market: Singaporeans invest in Singapore and have limited appetite to invest in

other Asian markets due to exchange-rate risks and the insufficient level – perceived or real – of information from and political stability in foreign markets. It will remain so in Asia for a while. Once they go international – which has been discussed for a long time but no massive investment shifts have yet materialised – they will probably prefer government debt from major OECD markets and from the US in particular. Another probable evolution in Asia is the development of a corporate-debt market, but again this has been slow to unfold.
Europe is yet a different and interesting case. A debt culture has been a characteristic of European investment for a long time, but long term, some shift to equity investment is unavoidable, by institutional investors at least, and possibly retail investors too. This was most obvious four years ago when the equity markets were booming. While it is more subdued today, the trend is undeniable.

You mentioned that the changes in the US market are more supply than demand-driven. Is this also the case in Europe?

PF: The change in Europe is actually due to both. Traditionally, for risk-management and psychological reasons, Europeans also have preferred to invest in securities of their own countries. A French individual would prefer to invest in OATs[1] and Renault shares than in German bonds or IBM shares. In addition, government debt generated satisfactory yields. The structural change we observe today is not the natural consequence of low interest rates – they will go up again – but of the Maastricht Treaty that has forced the national governments to limit their budget deficits, and consequently, their ability to float such bonds; government debt will take a smaller share of the total debt market than it used to. Additionally, corporate debt in Europe is growing but has not boomed as expected five years ago. As a result, the pool of attractive European debt securities has narrowed and precipitated a shift into alternative investment vehicles. The fact that, cyclically, we find ourselves in a low interest rate environment has further accelerated this process.
On the supply side, the non-domestic products now available on the financial markets are more attractive than before. In addition, the Euro has substantially eliminated one of the major obstacles to cross-border investment in Europe – exchange rate risk – especially for investors who do not believe they have the tools to manage this risk as efficiently as institutional investors. Therefore, they often hesitate to use the hedging mechanisms that intermediaries pro-

1. French Government Bonds.

vide. Deregulation of UCITS[2] has been another factor facilitating cross-border investments over the last decade. If in the past, it was complicated and costly to pursue such strategies in Europe, now the obstacles are diminishing.
This combination of demand and supply drivers could lead to a faster reorganisation of European portfolio investment – starting at the wholesale level but continuing in the retail arena as well – than might be found in the US or in Asia.

More than three years ago, PROMETHEE described this journey toward a unified European financial market and the role distribution could play in freeing the European retail investor.[3] Yet, the evolution has been slower than would have been expected at that time.

PF: The financial industry does not change overnight! I also think that the speed at which change happens is highly correlated to the public's confidence in the financial markets, and the last several years have hardly reinforced this. First, there was the burst of the equity bubble, followed by corporate governance crises and the lack of transparency in companies' accounts, starting with Enron in the US and several other cases, including in Europe. The French, for example, naturally think twice before investing in an Italian company now that Parmalat's troubles have been exposed. This is, of course, a psychological conundrum: how much more do investors really know about their domestic companies? But people are worried about investing in the unfamiliar. They have a strong home bias and when something happens abroad that is a source of concern, they often withdraw. It will take time for familiarity and trust to expand beyond natural and cultural boundaries.

Is there not also the local belief that the national government will not let down a large domestic-listed company?

PF: It is part of the logic. Indeed, most Italians probably thought that if Parmalat had a problem, the Italian government would have provided a safety net, but this did not occur. The stock market crash and the ongoing accounting scandals have affected people's willingness to invest in equities and have made it more difficult for intermediaries to develop more efficient investment products. However, the trend is there and the political will to develop a financial market able to support the European economy is too strong for it to disappear.

2. Undertakings for Collective Investment in Transferable Securities. These harmonised collective investment undertakings can operate throughout the EU: they include unit trusts, common funds and SICAVs. Their total assets amount to around four thousand billion euros.

3. See Albert BRESSAND & Catherine DISTLER, *Bridging the funds divide* (Paris : PROMETHEE, July 2002).

Another factor that should contribute to the move toward an equity culture in Europe is the pension problem that we know Europeans will have to address sooner or later…

PF: Absolutely, and not only in Europe but elsewhere as well. Very little progress has been made during the last three to five years and we all know that it is a very touchy political subject. However, one would have expected governments to encourage alternatives, such as supplemental pay-as-you-go pensions.

Pension funds will develop in Europe but I don't know whether we will see 401K plans or Individual Retirement Accounts[4] here as they exist in the US because they could reduce monies from the public-pension schemes that presently redistribute money to retirees. Europe is not the same as the US, but change is necessary because we will otherwise have insufficient public-pension funds fairly quickly – in 15 to 20 years or so. Therefore, whether it is the result of governmental action or of a sudden crisis, massive funds will be invested through instruments that are ultimately supplementary to public pensions.

How active have intermediaries been in promoting cross-border investments in Europe?

PF: Intermediaries are very creative at managing regulatory constraints. However, until now, their solutions have been costly and complex, and mainly useful to sophisticated investors – wholesale clients and investment banks investing, for instance, for their proprietary activities. The more obstacles that are lifted, the easier it will become for intermediaries to develop new products that are sufficiently straightforward, transparent and low cost to cater for a broader range of investor needs. This is one of the reasons why we anticipate in Europe an increase in the number of intermediaries selling mutual funds and UCITS, and of third-party fund distribution. This will give private investors more possibilities to compare prices and products.

Disintermediation has been widely debated in Europe and worldwide. Do you see such a trend developing? Are new categories of actors – retail investors, insurance companies… – becoming Euroclear group clients?

PF: Indeed, there are a few countries in Europe where the ultimate investor is

4. These allow people individually to set aside money for their pension in a way that is encouraged from a tax point of view.

the direct account holder in the local CSD for risk reasons: Sweden, Denmark and to some extent the UK. However, these investors do not manage their accounts directly, but delegate such tasks to sophisticated intermediaries. This is why retail investors will not propel a massive evolution in the use of Europe's financial-market infrastructure. As cross-border investment becomes simpler and cheaper, some sophisticated individuals will displace intermediaries. This is the very evolution that Internet-trading has brought to the US, and to a lesser degree in Europe. But, only those with substantial market expertise and funds will be able to take advantage of this trend and because of this, disintermediation on the part of private investors is going to happen on a small scale.

There are a very limited number of insurance companies or corporations that actually want to be active in the repo market and are financing themselves directly using Euroclear Bank's tri-party collateral management service. But, otherwise, our clients' customers including, for example, pension funds, corporates and other institutional investors, are not coming directly to us, nor are we seeking their business. In the past, a few insurance companies and corporations have tried to re-insource some of the activities outsourced previously to global custodians and others. We see just the opposite right now: they tend to focus on their core strengths and to delegate to global custodians the management of their securities investments. In all likelihood, the pendulum will swing again in a few years. Regardless, we see Euroclear Bank's role as continuing to work with global custodians and other intermediaries, rather than with their underlying clients, as a long-term trend.

We have seen how global Euroclear Bank's clients are, and how Euroclear positions itself with respect to the international part of the business. If we move from clients to products, how global are the products on the financial markets?

PF: On the product side, globalisation is the general tendency of the market to look for substitution options between products. One example is the process of cross-collateralisation. In the past, an investment bank needing financing in French francs for a transaction would have collateralised it with French securities. This had been changing for some time, but has been accelerated by the Euro's advent. Thus, German bunds may now be used in a cost-effective way to back UK sterling positions, and it is no longer uncommon for fixed-income securities to collateralise equity positions as the strong growth of tri-party collateral management products has evidenced.

The shift from cash to derivatives markets is another substitution effect at the product level. It is not a consequence of globalisation, nor is it totally disconnected from this process. As obstacles are being lifted, financial markets look for creative ways of developing competitive services and Euroclear Bank is a leading example of this development.

Are not the lack of standardisation of market infrastructures and communication protocols, and of harmonisation of market practices key obstacles to the creation of an integrated European market?

PF: Standardisation and harmonisation is at the same time the major challenge and the major opportunity for the securities industry over the next five to ten years. European deregulation started in the '70s when new Directives allowed intermediaries to offer their services on a remote basis, but many obstacles remained until the Euro's rollout. Since then, intermediaries no longer tolerate the high costs of cross-border activities, a phenomenon which has applied enormous pressure on market infrastructures, institutions and sub-custodians. CSD and ICSD fees, for instance, have declined annually and the rate of such declines could accelerate in coming years. In fact, pressure is now being placed on the stock exchanges: some of them have increased their fees while demutualisation has diminished the control that users had previously, and competition has not yet led to liquidity shifts. We'll see whether the London Stock Exchange is able to actually compete with Euronext on its listed equities and vice-versa.[5]

Harmonisation of market practices is a complex exercise. There have been a number of Cassandras about European harmonisation, arguing that a homogenous market like the US cannot be replicated without certain standards: language, culture, legislation, etc. But, I believe we don't actually need to be as homogeneous as the US to have a more efficient market and to generate a higher appetite for cross-border European activities. We need to distinguish between harmonisation that market operators, themselves, can engineer from those that require legislative or regulatory changes. While the efficiencies that can be generated by market-practice harmonisation may be a fraction of the total synergies we could get if Europe were as homogeneous as the US, they are nevertheless massive in absolute terms. They may not be easy to obtain, but they are obtainable, and Euroclear is putting its full weight in the balance

5. Since May 24, 2004, the London Stock Exchange offers trading in 50 Dutch stocks to compete with local market Euronext.

to make it happen. If executed intelligently, market-practice harmonisation would allow us to simplify our internal processes, to have one single platform for and one single interface with all our customers based on market standards. Done in a way that is consistent with our customers' technology developments, it will give them greater control of their own costs. In essence, the role of Euroclear is to accelerate this process and to simplify the cross-border world.

Do you mean that Euroclear can be one of the key drivers of the standardisation of the whole European market?

PF: We need to standardise for our own purposes but, even more important, we need to do so for our customers. The impact of standardisation is, of course, far-reaching: for every Euro we save by reducing our own costs and our customers' fees, there could potentially be 5 to 10 Euros of cost reduction in our customers' 'back offices'. The total excess costs of cross-border activity in Europe, which has been estimated at about 5 billion Euros, could be reduced by over 1 billion Euros this way, an unfeasible reduction unless the market-infrastructure providers help that process.

It is often argued that consolidation of market infrastructures is really good only for the big American banks. Would you agree with this analysis?

PF: Harmonisation and simplification actually do not favour American investment banks that are trying to assert themselves in Europe. For instance, look at how well the US global custodians and investment banks have already done by managing for their customers the fragmentation and inefficiencies of the European markets. This requires expensive technology – unparalleled thus far in Europe – to allow them to have the processes and services for their customers that are smooth and efficient. Few financial institutions in Europe have the financial wherewithal to support such large investments and this affects their competitiveness significantly. In fact, by reducing the cost of being active in the cross-border world, particularly in Europe, Euroclear makes it easier for many European institutions to be more competitive compared with the largest commercial and investment banks.

Alberto Giovannini articulated a similar argument to European MPs about financial markets generally when he was asked if cross-border facilitation would not be fatal to the financial centres of small and mid-size markets. His answer was that the harmonisation of legislation and market practices is not only useful, but probably a prerequisite to the survival of local financial centres.

Harmonisation is reducing the barriers to entry and boosting opportunities for smaller companies and markets.

How does a company like Euroclear position itself to be successful in the global market?

PF: Our business is a critical-mass business in which economies of scale are large. Substantial amounts of money need to be invested in technology and other support vehicles to provide the right services to our customers.

In addition, the value for customers of doing their settlement and custody business where their counterparties do – what the experts would call network externalities – is also very high. Single access, book-entry settlement is much cheaper than blended forms done partially in our books and partially elsewhere, whether it is a local agent, Clearstream or a CSD. The cost of doing a non-book entry – an external – transaction compared to a book-entry transaction is especially high on the equity side. This is why, over the past two years, we have created at Euroclear Bank a single, book-entry settlement solution for Euronext and London Stock Exchange trades. Settling a French, Belgian, Dutch or UK equity transaction on our books costs about 1 Euro, on average (at the lowest 55 cents for very high volumes and 2.25 Euros for low volumes); the same transaction would cost 5 to 10 Euros if it is not book entry.

In addition, book-entry settlement is lower in risk and has additional benefits such as reduced financing costs for customers because DvP is immediate and assets become available for collateral purposes much faster. When settlement takes place in different providers' books, there can be a time gap between the moment the customers' assets become unavailable in one book and available in the other. Book-entry settlement is thus a facilitator of intra-day asset use. Close to 90% of all the transactions that take place in Euroclear Bank's books are between two of our customers, i.e., book-entry in Euroclear Bank.

While settlement is a critical-mass business, this does not necessarily imply a monopoly. Competition has been a driver of innovation, service quality and low prices in this line of business too, and we must ask ourselves whether we actually need to reduce the number of players in the industry to one. We currently still have more than 20 CSDs in Europe and more than 30 banks offering local custody services, of which a handful offer multi-market services. The number of intermediaries will reduce naturally because customers are increasingly looking for cheaper and coherent multi-market services. The IT and expertise investments required to provide multi-market services are significant, while the profitability of the sub-custody business is eroding at the same time. However, I don't believe that users would necessarily like to have a single provider, whether it is Euroclear or anyone else. Rather, I would expect competition among perhaps half a dozen different providers.

Can the same conclusion be applied to another critical aspect of the securities business like global custody?

PF: In global custody, customers also want choice. Euroclear Bank is, however, not a global custodian; rather, global custodians rely on an institution like Euroclear Bank for the commoditised part of the business. Some of these commoditised services will be offered by market infrastructures like Euroclear or Clearstream, while others will be offered by custodian banks. There will be some overlap, so competition between these entities is critical. A few banks are now lobbying to avoid competition from market infrastructures. If these efforts are successful, the 50% reduction in custodian banks' fees witnessed over the past few years – due to fierce competition with Euroclear Bank and others – could potentially be reversed.

Of course, local custody (sub-custody) is not a high-margin business. Fees are not necessarily the most important element for users; reliability of service is the most critical. Customers want to know that an instruction for settlement will be executed immediately and they value high settlement efficiency. Today, our overall settlement efficiency has reached its natural ceiling of close to 99%. Yet, while in the bond business, 95% settlement efficiency would be considered very poor, for cross-border equities, 75% to 85% is still the norm in some markets. There is, therefore, room to improve.

Asset servicing, such as the processing of corporate actions, is also critical, not only for global custodians but also for investment banks. For instance, when dividends or coupon payments are distributed, they need assurance that the intermediary they use properly organises the collection of these payments.

The cost for customers of low settlement efficiency or inadequate asset servicing is substantially greater than a reduction of 10% in their fees. Quality service is absolutely essential.

These remain the two main pillars around which Euroclear Bank tries to position itself and to be competitive: large economies of scale to reduce costs to customers and high levels of service quality.

What does the value of the brand mean to Euroclear?

PF: When investors go from pure domestic investments to cross-border investments, trust is paramount. How do you convince a new customer to trust you? Branding is part of the argumentation, because it reflects your track record. Behind branding you have two issues: making sure that there is a concept attached to the name of your company (what does Euroclear mean to people?) and trust. Euroclear's brand, and the reputation of the CSDs within the Euroclear group, has helped us over the past few years when we embarked on significant – and expensive – investments to develop a common technology platform for the group that will be used by all our customers. Customers must be comfortable that the platform is going to be delivered on time and in a stable way, and this is where our track record helps. Euroclear is now benefiting from its past excellence. This derives not only from the track record of Euroclear Bank, but also that of Sicovam, CREST, and Necigef, which have launched, over the past ten years, a number of complex technology projects: in France it was the RGV project, CREST launched its original platform to replace Talisman and Euroclear Bank managed a series of major projects including the creation of its real-time settlement platform. To have launched all of these major projects successfully is a bonus because we like to think that 'trust' is an integral aspect of our brand.

Our mergers with national CSDs – Sicovam, Necigef and CREST – have been successful. Although merging successful companies such as these often requires a more delicate integration than absorbing a failed entity, the major advantage is that the credibility that each has had individually actually coalesces at group level. Credibility under one roof exceeds the sum of its parts.

Trust is also what is needed when the market is going through big changes like harmonisation and platform consolidation. Our success depends not only upon the quality of our people but also the firm conviction of the market that these changes will happen. Our reputation helps us in this process. But, we have to use it carefully because reputation is something you build over a lifetime, but can loose in a minute.

It's one thing for customers to believe that Euroclear will be successful in delivering what it has promised, but it is another to convince them that the solutions you propose make sense not only for your business, but also for them, not to mention the market as a whole.

PF: The discussion we had earlier about whether our customers understand the competitive implication for them of platform integration is one of the conditions. Being a user-governed institution, the views of the market determine our priorities and their sequence. Our strategic line has to be clear to our customers and in line with their needs.

A further factor is our aim to develop solutions that benefit customers in their own back offices, developments which may, in turn, reinforce the logic for them to support our plans. Let me give you a practical example.

In the past, CSDs and ICSDs developed proprietary communication interfaces with their customers in their respective markets. They were cheaper than market solutions but, when viewed altogether, they involve multiple proprietary systems. Incompatibility is a major drawback. Because our customers tend to be more global, our interests have been geared toward smoothing this compatibility issue. Therefore, we changed our tack a few years ago and decided to move to a communication interface that was based on market standards, such as 15022, and the possibility to communicate by SWIFT or browser-based solutions, which our customers are now using internally for multiple purposes. By doing so, we generate customer loyalty which allows us to be more nimble from a strategic standpoint.

Another important characteristic is transparency. To sustain customer loyalty, we are very open in communicating our future intentions. In our case, this remains very clear: we have absolutely no intention to move up the value chain. We don't need to. We are very successful where we are today and our objective is to expand into the cross-border equities market with the same successful strategy we have long applied on the cross-border fixed-income side. Beyond this, in the future, we aim to provide the same types of services, i.e. commoditised services, as we offer today. We feel no need to enter the higher-margin businesses in which our major customers already are, or want to move to.

Therefore, we have paid a lot of attention to clarity and reliability, and whenever we have moved into new businesses, like collateral management services, we asserted our goals upfront. Take, for instance, securities lending. In that sphere, we deliberately limit our activity to fail curing. We position ourselves as being a reliable service provider over the long term. As a result, very few people have concerns about what Euroclear is going to do in five years time and this assurance makes a difference.

On May 1, 2004, the European Union was enlarged by 10 new members. What will be the consequence of this historical move for the European financial markets as a whole and for Euroclear in particular?

PF: Enlargement could help accelerate the development of a broader and more homogeneous European market. In the banking industry, some of these markets have been able to leapfrog directly to the 21st century and the same may also be the case in the securities industry. This would be good for us, for our customers, and for those markets on a more general level. However, the financial markets in these countries remain small, so that, in macro-terms, enlargement will not change the global picture to a significant degree.

Is Euroclear a European or a global company?

PF: We have customers from 80 countries and we serve more than 30 markets in Europe, Asia, the Americas, and the Middle East, so we are essentially global. It is true that our major focus today is on building and streamlining the infrastructure in Europe, but we continue to see Euroclear as a stepping-stone for non-European institutions investing in Europe and for European firms investing in the rest of the world. Our strategy has always aimed at being a global company and it remains so.

Lucio Loubet

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