

Progressing Financial Markets

PFM04 - Challenges

With Richard Balarkas, President & CEO of Instinet Europe, and Mark Austen, European Managing Director of SIFMA,

Mike O'Hara: Voices In Business presents "Progressing Financial Markets", a podcast series sponsored by IBM.

Episode 4, "Challenges facing the industry" with Richard Balarkas and Mark Austen.

[intro music]

Mike: Hello and welcome to this episode of "Progressing Financial Markets", a podcast series brought to you by Voices in Business and sponsored by IBM.

My name is Mike O'Hara, and on today's show, where I'm joined once again by Keith Saxton, Global Director of Financial Markets at IBM, we talk to Richard Balarkas, President & CEO of Instinet Europe, and Mark Austen, European Managing Director of SIFMA, the Securities Industry and Financial Markets Association, about the various challenges that the Financial Markets industry is facing.

Well gentlemen, welcome to the Progressing Financial Markets podcast. It's good to have you with us.

Richard Balarkas, if I could start with you... 2008, I guess by any standards that you care to judge it by, was probably one of the most disruptive years ever for the financial markets industry. Now as we sit here in January 2009, what do you see as some of the major challenges that are facing the industry in the wake of such a turbulent year?

Richard Balarkas: Well, yeah. You're right. 2008, for the last quarter at least, was quite a shocker. Brokers don't mind volatility too much. It tends to drive volume. Volume drives commissions. Commissions equal revenue. But as we came to the end of the year, the financial crisis that hit the globe translated into the equity markets as little volume. And in effect, the volatility became far too great for any kind of money manager -- depressed assets across the globe, uncertainty. So volumes declined untypically before they normally do as we move into the Christmas season. And again untypically, volumes in January have not seen a step up, which is what the market has witnessed in recent years. So the huge challenge going forward is fundamentally low volumes. And there's lots of reasons why we're in that scenario. Lots of things that will need to be addressed, but low volumes will be threatening a lot of business models that people have just grown up and been accustomed with for generations now. But it could lead to significant changes in the business models, especially of the bulge bracket.

Mike: Could you maybe elaborate on that in terms of the business models that you talk about, and how they are going to be impacted by this?

Richard: Yeah sure. If we look at the traditional bulge bracket business model, then it's a case of bundling together as many services as you can so that clients becomes sticky for all kinds of reasons. And generally so that they pay bundled commissions, and generally as well the hope that they overpay. They trade too much. They're paying for things they don't really consume. They're paying for things they not only don't consume, but probably have little value.

And if we look at, for example, the cost base of an equity research operation. Now when the markets are good, you have a virtuous circle. Good analysts, highly rated analysts means you tend to get IPOs, which means you can hire good bankers, which means you get good secondary market share, means you can get even better analysts, etc., etc.

We're looking at a situation now where everything analysts have known in the past is basically dislocated. I mean I can remember a time where if the oil price moved 50 cents then every analyst would reach to their Excel spreadsheets and they'd be able to pump out a new bit of research on 20, 30 companies that might be affected in some way by that oil price movement.

We've just seen oil prices shoot up to record levels. We've just seen them collapse to \$34. And you know what? It just isn't affecting prices. That's just one small example of the way in which everything everyone knows about the markets is dislocated.

Now the fact is as we came into last year -- I think the Bloomberg survey of analysts on what was going to happen to the S&P 500 -- there was a consensus that it was going to rise about 17 percent. Not a single one of them forecast that the market is going to go down.

As we come into this year, the same group of analysts, their average consensus is the market is going to up 11 percent. Now you know what? They may be right. They may be off by a few points. But pray tell me, why would people pay for that viewpoint?

So not only the strategists, but as you move down to single stock level, the value of what these guys are putting out -- it's got to be highly questionable. Not only that, but it's always been paid for by transaction flow. Now if no one's got any transactions, then there's insufficient volume to carry the tax which goes to pay for all these bundled services.

So the bulge bracket firms, at the moment, must be suffering a huge amount of pain because they are not even focused on execution. They're focused on a much wider array of services that builds out their costs. But the only way they can get paid is through an execution, a transaction. And they're just not there.

The kinds of things that made it work, that generated the additional fees, are gone. Yeah? Volume's gone. The trading models hedge funds used -- gone, broken, don't work anymore.

So that bulge bracket model is going to be feeling an awful lot of pain. And of course, not many people perhaps in the bulge bracket firms want to be talking about this. But I'm happy to.

Mike: I'm very glad you are!

Mark Austin, you're the managing director of SIFMA in Europe. Now some of the things that Richard mentioned there as the key challenges, such as the complete drop in volumes -- the old business models or some of the new business models having to be thrown out the window and going back to square one. Are you hearing similar things from your members?

Mark Austin: Yeah. From my side -- I'll try to take a look at this more from the fixed income point of view. And if you look at what's happened in the fixed income markets in 2008, it's also been revolutionary. Back in 2007 you probably had basis point spreads of 20 between Greece and Germany. And now we're at 275, which is just being a complete shocker for Greece and for those that are in that situation.

You've obviously had, in 2007, a real flight to quality. Where's that quality gone? Well, it's gone to the big currencies -- US, Euro. And it's gone to the government bond markets. So you had a situation in 2007 almost unheard of driving the US Treasury T-bill into negative yield. People wanted it more and were willing to take a loss just to hold it.

So that has had a major, major impact on the market. And then you bring that out into the credit market, and you take products such as covered bonds, which were once trading like rate products up until recently, and were seen as basically as surrogates for the government market. And that market is now almost shut.

So what's happened is the governments have stepped in. We've got a lot of this government guaranteed stuff around. Started issuing it the end of last year. There's been a lot of issuance in the first couple of weeks of this year, which has all been taken up by the market, so there's obviously people out there with money that are willing to buy something at the right price.

But, again, this kind of fundamentally changed these markets. And that the same holds for the fixed income world as the equity world. I think that analysts, the research, all of those models have been kind of thrown out of the window.

So because of that you don't see people in the market where you had these dislocations, which would immediately kind of bring them back in because they had a model that would take that into consideration and push the market together.

Now you have a situation where you have government guaranteed issuance trading in some cases higher than a comparable government bond. Which you think, "Why would that be?" Why would you pay more for the government guaranteed stuff backed by a triple-A country, and you're getting a better deal on something like Belgium?

So all of this has thrown everything up for grabs and up for new models. And as you started off with, what happened in 2008 is almost unprecedented. And there's still a huge credit crisis going on and people aren't lending. So I can't see things getting better at least from the word I hear from the people on the street until the credit markets start recovering.

You've got to create a credit model where lending can happen and where funding can happen at reasonable levels. And where you can get, obviously, investors buying things that's not backed by the government.

So you're going to see, coming down the pipeline at some point in time, bigger, larger liquid instruments which are much more standardized, much more simple. I think we're going to go back to more plain vanilla, and that's what's going to start driving the fixed income market.

And once that gets up and running and that gets back and it becomes healthy, then you'll start seeing more complexity coming back into the market.

Mike: And I'd like, maybe a little bit later on in the conversation, to look at that in a bit more detail -- about how liquidity could be restored to the credit markets.

But Keith Saxton -- from conversations that you've had -- I mean you go out and talk to a lot of firms, both on the buy side, the sell side, and the exchanges, the trading venues and so on. Again, are you hearing the same messages? How do you see these firms looking to adapt to these kinds of challenges?

Keith Saxton: I think clearly it's immensely challenging for all these firms in the marketplace. I would entirely agree with Richard and Mark. I mean, the business model is just really shot. So the question is -- typically when you have a pull back in the market you'd have maybe one or two lines of business that were in trouble, and you'd be bailing them out with a third line of business that might be doing OK. You'd typically find banks that had a strong balance sheet that would actually be stimulating some demand for distressed assets, putting a floor under prices, and actually getting a bit of confidence back.

But the reality is, I think, that most big profit pools have actually disappeared. And they've not just disappeared for a period of time. They have potentially disappeared for the foreseeable future. And really, when you start to analyze that, there's probably a couple of things that will need to happen.

One is you're almost going back to innovating back to basics in reality. So what does an investment bank do? So now they're all bank holding companies, but the function doesn't disappear. A functioning capital market is enormously valuable for any economy. So that intermediary role that the banks play in the capital markets is immensely vital to restarting the economy.

So one of the dilemmas and one of the real progresses we've seen in the market has been the electrification of many instruments. And so the banks actually have got a very, very high cost base to support a lot of this volume that's been going electronic.

But there's a cost associated with keeping that business afloat. So there's the dilemma of, "What do you imagine your long run cost of that business is? What's the right ROE of that business line? What's the normal? Is it, say, 12 percent or is it 25 percent? Was 25 percent just simply unsustainable?"

So what we're talking to many organizations about is just really how you start to look to the future, and decide what it is you want to be. So you have a risk profile attached to that. Do you actually want to assume risk? Do you want to lay off risk? Do you want to be an advisor? Do you want to be some sort of broker? It's really up for grabs.

But I think the simple reality is most banks will have to spend a significant amount of money on transparency that's going to be a requirement from government regulations, from their own boards in effect in terms of what people are producing for risk metrics and all the rest of it.

So I think there's a number of real difficult business stress points which have to be tackled together. And of course, there's always spring beyond winter. This one's going to take some time to work through, I think.

Mike: Indeed. Richard, coming back to you, one of the things that Keith brought up then was the electrification of trading. And we've seen a number of new trading venues in the equities markets over the last couple of years. And liquidity is fragmenting across all these different venues. Can we talk a little bit about what is going to happen in that space? Obviously not all of these venues will be surviving in the long term. Or maybe they will. What are your thoughts on that?

Richard: I find that a difficult question to answer without being at risk of sounding completely schizophrenic, because what's happening -- and it took far too long to happen -- is that exchanges are simply facing competition. And it's limited. Right? It's not wholesale competition. It's a limited little battle that's going on.

Once upon a time when exchanges had trading floors, we've got to remember they did a good job because to get on that trading floor you had to have the right cut of suit, make of tie, and everything else. But it was, to a degree, managing counterparty risk. If you were a member of the club, you were looking after counterparty risk. And hey, don't we wish people were looking after counterparty risk given the experience we've just been through.

So it's a good function. But then they were blown apart, and I think the fundamental change that took place with Big Bang and the transition to order driven trading -- with Big Bang II in the UK, and we've seen it in the US as well, and it's happening in Asia -- is a situation whereby the structures of the exchange, even though they were now systematic, order-driven trading books were simply inadequate for some of the more modern models. The faster trading models that we know drive liquidity on a lot of the new venues.

But the big exchanges are not really competing with each other yet. So there's a long way to go. How it pans out is difficult because I think what the new guys are proving is that running an exchange isn't/can't be/shouldn't be a license to print money.

So this is where it starts to sound a bit schizophrenic because if you look at these new venues, how much market share are they going to get? What are they going to have to do to survive? Well the margins are skinny. I mean these guys have gone in so cheap on price, the only way sustainably moving forward is for consolidation to occur.

So you've got a fixed cost platform. You just pump as much volume across it as you can. Get more volume on it, you make more money. They're going to have to do that.

Where do we end up? Possibly with a monopoly provider. Right?

[laughter]

We end up with the same problems that we had.

So I suppose one final comment is that traditional exchanges do have the disadvantage, they are not that focused, as much as the newcomers, on running technology. The newcomers are a classic example of a supplier moving into their client space. It's just the IT guys thinking, "You know what? We could do that, much cheaper." So they've gone and done it.

Mike: Interesting. Mark Austin, I was wondering if you could maybe compare and contrast the fixed income and the bond markets -- how liquidity is fragmenting, if it is fragmenting in those markets -- compared to the equity markets that Richard's been talking about?

Mark: Yeah, in the fixed income markets it's traditionally a very different market than FX or equities. I mean, FX you've got a few pairings so you've got a lot of liquidity concentrating on that. In equity, you've generally got one issue after you have IPOs obviously. But if you want to get in and out, if you want to realize your capital gain or loss, you've got to sell.

What you do find, and what you found obviously in the last number of years, is that after the turn of the century it really moved in a big way to electronic trading, in particular on things like government bonds.

What's really happened since the crisis is that a lot of the business has gone back over the phone. There's been so much volatility in the market and volumes have gone down to such an extent that people simply don't want to reveal their positions as much. So they're less likely to trade electronically, and they're more likely to go through the broker.

So the electronic trading, to an extent, has taken a bit of a hit. There was a lot of move and discussion before the crisis to move to a more exchange like model -- let the hedge funds in, let the hedge funds provide liquidity.

That's sort of dried up. The hedge funds have gone away. They're not in this market. They're not as active anymore. So therefore it's gone back to the old kind of dealer verses customer market.

What has happened, and what actually SIFMA and European Primary Dealers Association have been on the forefront of, is that there was a lot of concentration on one particular platform in every different country. And that was backed by the Debt Management Office requiring you to trade on one particular platform. We've worked quite actively to kind of break that monopoly so dealers in most countries have a choice and they can choose whether they want to make their market on two or three or four platforms.

So we've actually seen there's actually been a lot more competition between those platforms. Cost of trading has come down somewhat and that's been kind of a good development in the market which has kind of gone unseen because of everything else that's going on. People don't take a notice to it.

Mike: So we are where we are now in this position with lack of liquidity, lack of volume. The credit market's kind of stuck and that's filtering through to the bond markets and so on.

How are we going to see the “green shoots of recovery”, to coin an expression, come back? Who wants to tackle this one in terms of what you see as being the kind of steps that the markets will go through to restore some semblance of normality?

Keith: I think there's a degree of focus on the fundamental root of some of the problem, or a major part of the problem. So if you take this all the way back to subprime, the lack of transparency around individual mortgages and the lack of ability to see where these pools are, or how to value them and all of that that is a requirement, really. [28:50] I think so that's very specific to start to really unfreeze a really big proportion of the market that clearly is vital to trying to reopen the securitization market, trying to give people a view that actually securitization is not all bad and it's a real sort of benefit to the firms being able to repackage and reutilize some capital.

Credit default swaps which have been blamed, probably unfairly, in its entirety for the crisis, but we'll get some confidence back in credit default swaps. We're going to one, two or three central clearing houses, which I think, although it doesn't take away a lot of the systemic risk we've had, takes away some of the opaqueness of that marketplace. So some confidence might come back there.

And ultimately when you go around and talk to the regulators, there is a real national focus. So I think this is going to be tiny building blocks. It'll be national markets that will try and rebuild because they need support, their own issuance of debts.

You know, it'd be wrong of me not to mention the role that technology could play in that, but there is clearly...will continue to be really a positive impact of technology in terms of what this will enable you to do.

And I think there's most definitely a refocus on the client, whomever that client is,

Mike: Would you agree with that, Richard?

Richard: Yes. You know, compared to other businesses, my business is pretty simple. It's just agency brokerage in one asset class, equities, in one region, Europe. But I think it's pretty complicated when I come to work every morning and some of things that hit the desk.

I agree this is going to be a long-term problem and I think it's only going to start to get better, that confidence factor we were just talking about, is only going to arise when we're in a scenario we actually do recognize and understand.

You know, I applaud the confidence of governments and regulators with the actions they're taking at the moment, but that's what they're primarily doing is displaying confidence.

At the moment, we are in the land of unknowing.

Mike: One of the unknown unknowns, I think.

Richard: Yes, we mentioned the winter season before. You know what? This could be autumn that we're going through at the moment and until a lot of the bad, the rot that is out there that we just don't understand, has actually fed through into the economies, into sectors other than finance and mining and commodities, which it's yet to do...

Keith: Do you think there's some value in taking away the toxic debt and actually trying to establish some sort of floor? I mean, Mark, you might have a view of that from your perspective.

Mark: I definitely do. If you look at history, any kind of major credit event that we've gone through in any market takes a long time to work through.

It's going to start with setting those floors, whether that's through government action or other action.

It's then going to be step-by-step, with investors coming back to the basic standard, plain, vanilla instruments and wanting a little bit more yield. Just taking that little bit more risk and building confidence. Building from there and moving on.

You saw what happened with the subprime in the US and it just polluted the whole system.

All of a sudden, investors woke up and said, "What am I actually owning here?" And, "What's it really worth? Do I really know what it's worth?" And people just panicked.

So it needs global solutions. Regulators really need to sit down and say, "OK, let's stop the fighting and make sure we're cooperating."

The view that I have through my colleagues at SIFMA when they deal with the EU, they're extremely angry at the US. The politicians or regulators are all blaming the US. That's got to stop. We all have to take responsibility for this.

I have to be honest. Rarely do I walk into an office of a regulator and think, wow, this person really knows the market, especially when it comes to fixed income markets, especially when it comes to derivatives. Those markets, they really have to understand better, understand what they're regulating. And know when they have to put standards in place and know when they can let the market do what it needs to do.

Richard: On the question of separating out toxic debt, it may well--and I don't know, I'm not an economist--but it may well help getting bank lending going and getting the credit markets going again. Try and get things functioning anything like normal.

What I've heard in the equity markets since I joined them 20 years ago is that the bad times never last long enough, because everyone hopes in the equity markets that some capacity's going to get taken out and the bad performers move out of the game, and it becomes more productive for those who are able to survive, who run their businesses properly.

Mike: So there are lessons to be learned that aren't being learned.

Keith: The governments are going to require a lot of disclosure. You can track that through political conversations going on in the state. You would expect that in every single country. So whilst the regulators and the governments are quite keen not to impose something quickly, such as a Sarbanes-Oxley type of result, you're definitely going to find that they want to know exactly what you're doing with that money and what precisely is your business model.

Back to the point we made to very early on in the conversation, it's almost back to a core competency. It's back to a basic model of what actually you do, if you say you do, the capital markets function. Well, what is that? Do you do it well? If you say you do retail banking, what is that?

In the capital markets, financial markets, has any firm--probably one or two--has any firm really got the golden copy of the trade? Do they have horizontal capability?

So when the regulators come along and say, "In an hour I want your true counterparty exposure right across the firm. I want all of your risk within half an hour -- your liquidity risk, your collateral risk, your counterparty risk." We know today they can't do it.

Whether it takes the winter to come along or whether we just spend another two years going sideways in the markets, there's, hopefully, going to be a realization this truly is a once in a lifetime opportunity for people to look at a different model and do something about it.

I think the winners -- if we're talking about who's going to survive and who are not -- it's the people who very quickly get that it really has changed. Nobody knows what the new norm is but people are willing to take some really difficult decisions.

So whenever we've had a bear market in the past, people have started to think about, gee, our infrastructure's too expensive, or we've got too many people. Or, we've got this and we've got that. They do some actions, but then the market recovers. The sense of it is this time it's just not going to be that simple.

Some of these other decisions are actually quite difficult, but nevertheless, they need to be taken.

Mike: I'd like to bring this to conclusion. Maybe, within the closing thoughts, what kind of role you think that technology can play in the recovery of where we are now? Mark, we maybe start with you.

Mark: I'll think I'll close with a response to the last two comments, in relation to the banks. There's definitely a huge moral hazard in bailing out the banks. As both last two speakers have referred to, you could end up just propping up the bad and we end up being here in two, three years from now and you've got all the same players on the table.

On the other side, the problems that governments face is that they saw what happened when they let Lehman go bust. They saw the impact that had on the market. They saw the impact that that is now taken over into the real economy. Everyone can argue either side, whether that was Lehman or other things.

But there's some real fear that they don't want that to happen again. So the view is let's prop these guys up and let's make sure we don't have those kind of events and shocks. We're going to have to find a way to manage yourself out of that crisis.

The problem there is how do you do that? How do you come to a situation where, at some point, you say, "OK, I'm going to let the weak one go down and I'm going to save the strong one," and beyond that? Do the individuals who are doing this, making these decisions in all the countries around the world, are they the ones--can they really make that decision? That's a big problem.

On the technology side, Keith just referred to it, which was risk management. Technology can play a huge role in that. Regulators will demand it. Transparency is a good thing, in that regard.

Regulators need to know effectively what the balance sheet is of a bank, what the risk is. All of that. I think that's what will happen in the coming years. To do that, most of these institutions are going to need new or, at least, very improved systems to be able to handle that.

Mike: Richard?

Richard: I actually find it difficult to see what kind or whether technology will play a specific part in any solution. I do agree with some of Mark's comments, certainly on risk

management. Some of what people have claimed is just too hard in the past, just isn't too hard. Certainly, when it comes to risk management, there are many firms who don't understand their counterparty risk, who don't understand their exposure, don't understand their exposure across asset classes in their own region, never mind globally.

These are the same firms who can bundle together the biggest companies on the planet and tell people what the share price should be. Then unbundle them, again, because it was all wrong, then tell people what their share price could be. So they're reasonably smart.

I would have thought that they could actually devote resource to fixing some of these problems. Even simple issues like the unbundling of commissions to separately pay for research and other services. Separately pay for execution.

When that was first considered in the UK, the official response of many parts of the industry was that it's just too difficult, which is really quite pathetic. Now's a good opportunity, I think, for people to get their houses in order and fix some of the fundamental problems.

Mike: Final thoughts, Keith?

Keith: Well, I think technology is not really the problem. You have to understand technology can do a lot of things that five years ago it couldn't. It will be able to do a lot of things in five years time. One of the tricks, here, is not to invent solutions that fix yesterday's problem on yesterday's technology, but, actually, to be a little bit more expensive about what can be done.

Now, again, we should be very clear. Technology wouldn't necessarily have stopped this sort of financial pandemic. But it, for sure, would have given us a better chance of early warning signs.

So you're back to transparency. What is it we're really trying to get to? It's not standards, per se, but those very disparate ways of even doing valuations. Each regulator takes a firm's view of what their valuation is. There's got to be a standard way of collecting a lot of data. There's got to be a better use of technology.

Investors need to know what's really going on in this market. I don't think that's as simple as OTC product going to an exchange. I don't think it's as simple as everything being very visible at the trading level on an exchange. There has to be disclosure. There has to be transparency.

Regulators and governments will demand it, hopefully, in an educated way. Hopefully, in a sense that utilizes the best of technology, not just imposes a set of restrictions on everybody. Technology is the heart of this; it always has been.

Mike: Gentlemen, thank you very much.

Group: Thank you.

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