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Our partner in developing this  
white paper:



## European Fixed Income: Ready for lift off

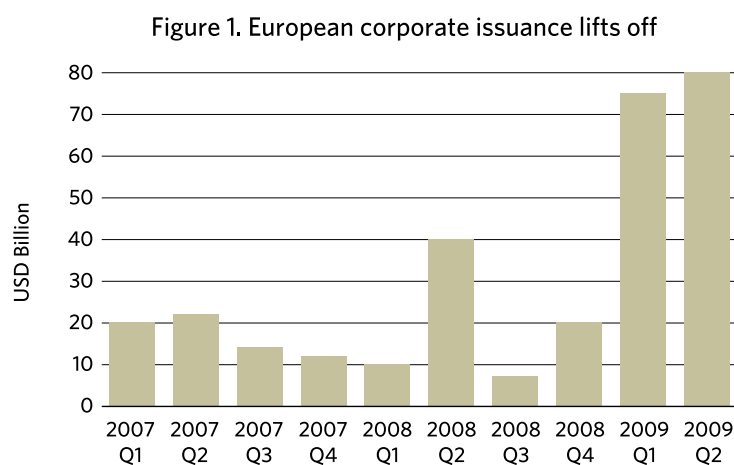
Since September 2007, the markets have been characterised by a massive withdrawal of investment banking balance sheet. This has been driven by tighter regulatory provisions combined with the emergence of a more risk-averse management culture within the banks. While large multi-nationals have continued to enjoy a business as usual service from the investment banks, smaller firms have seen access to credit dry up. The signs are that they will turn instead to the fixed income markets and debt issuance - rather than traditional bank loans - as a primary method for raising capital. This will have wide implications throughout the entire value chain as new entrants to the market - a breed of "New Merchant Bank" - look to seize an unprecedented opportunity in European debt markets. The market in Europe is now set to take off, growing significantly in terms of the breadth of institutions engaged in fixed income activity and transaction volumes.

Yet it is certainly not just execution and origination that are changing. The infrastructure supporting the post trade lifecycle is experiencing upheaval as a result of a rapidly growing market, years of under-investment, tighter regulation and rampant price pressure. Historically operating in the shadows of trading activity, the profile of post-trade infrastructure is increasing noticeably. In a market that has become less trusting of large banks, new solutions are being sought, not just from traditional banks and custodians, but from other market participants such as Clearing Houses and International Central Securities Depositories (ICSDs). In short, the infrastructure is undergoing a transformation, steered by increasing commercial pressures and the dismantling of historical divisions across asset classes, geographies and regulations. However, the journey towards this transformation is haphazard, with no coherent force driving change across the post trade value chain, creating a highly risky and volatile environment across Europe.

So what questions remain unanswered in this shifting landscape? Will we see more consolidation or more fragmentation? Will fixed income sit on the coat tails of the equity markets or adopt characteristics demonstrated in other asset classes such as FX? The forces for change are counteracted by significant barriers, and the change, while inevitable, could lie some way off.

## Back to the future

European fixed income markets changed at a stroke in summer 2007. Up until then clients had effectively become counterparties to the highly leveraged balance sheets of the big investment banks across the full range of fixed income products – which stretch from government debt right through to toxic assets. Afterwards, banks have been forced to substantially increase the levels of capital they hold. This withdrawal of balance sheet from trading activity, combined with the reduction of competition, has left a gap in the market that will only grow as Europe’s economies recover from recession. This, combined with low interest rates, has created the boom in corporate issuance shown in Figure 1.



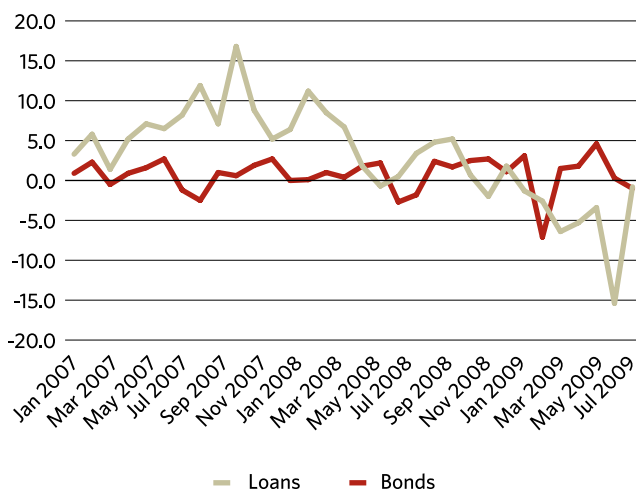
Source: BIS

Founded by ex-blue chip bankers with deep market knowledge and client relationships, these new players are embracing traditional merchant banking models, acting as broker and trusted adviser to their clients – going ‘back to the future’ as the founding partner of one of these institutions terms it.

This gap is being seized by many, from those seeking to capitalise temporarily on the wide bid offer spreads over the past year; to those with a grander, longer term vision. The latter – we estimate there are 20-30 of them – are backing a seismic shift in European fixed income, likening the opportunity to one last seen ten years ago when hedge funds were launched aggressively onto a buoyant market. Founded by ex-blue chip bankers with deep market knowledge and client relationships, these new players are embracing traditional merchant banking models, acting as broker and trusted adviser to their clients – going ‘back to the future’ as the founding partner of one of these institutions terms it. In a fixed income environment remaining characterised by banks having less capital to lend, experiencing tighter trans-national regulation, and with margins unlikely to retreat to pre-credit crunch levels, the potential for these businesses to flourish is being created. These new entrants – which we have termed the New Merchant Banks, echoing the pre-Big Bang industry – are creating business models that are not contingent on proprietary risk taking and large balance sheets. They are attractive to clients not just because of the lack of liquidity in the market but also because of their independence and lack of conflicts of interest. The combination of intellectual capital and strong client relationships presents an opportunity to add value to a market characterised by volatility and lack of trust, seeking out “good liquidity” as one new entrant describes it. One major asset manager – which uses these brokers to identify liquidity from other asset managers – estimates that New Merchant Banks already have 5-10% of the market.

Yet it is likely that, when spreads fall away, so will some of these new entrants. The successful ones will have established themselves as advisors as well as agency brokers, working with banks to analyse, understand and unpick the complex debt structures that are still sitting on balance sheets. The analysis and break up of these portfolios affords banks an opportunity to offload part of the debt sitting on their books, whilst offering cautious investors interesting opportunities to enter the market.

Figure 2. The narrowing gap between loans and issuance



Source: Bank of England

As debt markets in Europe grow to fill the capital gap – and issuance is already up hugely this year - we envisage that this new competition will loosen up the blocks in the market that have kept the finance directors of mid-cap corporations awake at night. This development will also be aligned with the regulators’ intent, determined as they are to see the markets released from the grip of the large systemic banks. And it will open up a secondary market that will continue to grow for years to come.

## Post trade upheaval

The business models of the New Merchant Banks hinge on client relationships and intellectual capital but with small balance sheets they cannot justify significant supporting infrastructures to process the transactions they arrange. In the post credit crunch environment a small capital base poses a major challenge when establishing trading lines with new clients. So the innovative new business models have embraced innovative outsourcing solutions that not only take care of operational overheads but also enable them to benefit from the balance sheet of their service provider, mitigating against credit risk concerns. In this way, the lending of balance sheet in the settlement and clearing space has enabled the New Merchant Banks to focus on building their service offerings and on marketing their core expertise.

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Interestingly, these 'give-up' outsourcing models bear strong similarities to the FX prime brokerage models offered to the hedge fund community over the past ten years – but with a very different flavour. The key difference between these offerings lies in the motivations of those adopting them, and offers an interesting insight into the wider changes afoot. Hedge funds adopted FX prime brokerage services in an environment characterised by a hunger for aggressive risk taking. Prime brokerage was all about creating leverage and increasing the ability to trade – and the credit risk was taken on by the FX prime brokers.

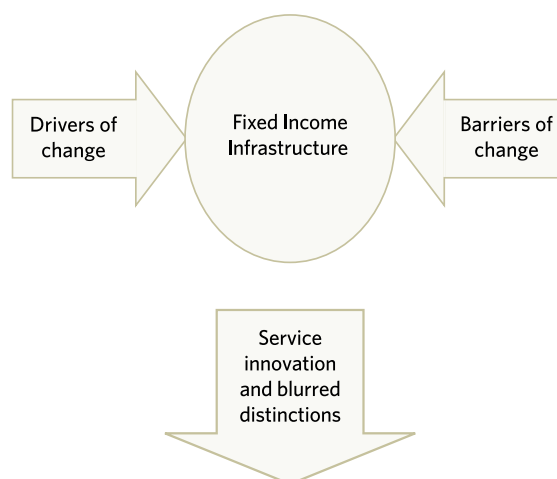
Conversely in the current environment, characterised by risk aversion, the focus is on de-risking the flow. While it is true that a give-up service allows a New Merchant Bank to execute trades many times the size of its balance sheet, this is what we might call more 'responsible' trading, based on DVP rather than pure leverage. In the early part of the decade, FX talent left investment banks to set up hedge funds and gear up to make alpha returns. Today, the fixed income talent setting up the New Merchant Banks is using similar trading models but with a very different risk model. This risk obviously remains, but is borne instead by clearers rather than brokers.

## Between a rock and a hard place

The appearance of these offerings is characteristic of a fixed income clearing and settlement space that is under huge pressure to change. Whilst the prevailing winds are blowing in favour of the New Merchant Banks, the conditions facing the business models of those organisations focused on the post trade value chain are more variable. Crucially, wherever we see drivers for change we often find countervailing forces acting as a barrier to inevitable infrastructure change.

We see today fragmented post trade infrastructures, which have been shielded historically by market practices, semi-protectionist regulatory regimes and steadily growing volumes. Fixed income has evolved organically as a series of OTC markets, organised along geographical and asset class lines, each with its own characteristics and historical infrastructure. This has constrained downstream consolidation, in turn embedding cost, complexity and inefficiency into the market. Unlike the equity markets, which have historically received the lion's share of investment in post trade infrastructure, fixed income remains the confused cousin.

Figure 3. The Value Squeeze



## The centre cannot hold

In Europe elements of this fragmentation survive, particularly in the southern European “Club-Med markets” such as Greece and Spain. These domestic bond markets have retained their own settlement infrastructures, despite the growth of central clearing and ICSDs. The result has been a European landscape of jumbled up domestic and international settlement and clearing platforms, domestic, regional and international CSDs as well as a network of domestic and international custodians, which have together created a complex and expensive network of post trade platforms.

However, these national infrastructures are now facing the chill wind of change as a raft of initiatives such as Target 2 Securities (T2S), Euroclear single platform and Clearstream link-up all push towards an inevitable conclusion – centralisation. Regulation and pricing pressures are beginning to strangle these infrastructures, and we anticipate that regional and domestic players will simply disappear. Yet, whilst T2S and other initiatives offer a vision of European inter-operability, the initial focus on equities and the long implementation timescales act as major disincentives for short term investments - so a volatile and confused picture in fixed income looks set to remain.

The historically lucrative, if unexciting, business of custody is also under threat. The wide adoption of clearing models in settlement and the inherent netting opportunities these mechanisms provide has seen volumes decline steeply. These issues are compounded by the commercial pressures facing infrastructure providers across Europe as they watch transaction costs fall. Participants are faced with the dilemma of choosing whether or not to remain in an industry that is seeing falling volumes and downward pressure on prices. Consolidation is inevitable – and not all will either remain in the industry or survive. Those European participants who do remain are facing a volatile market that will require significant investment over a long term horizon to address. No other industry is as infamous as banking for its short term investment outlook, so the ten year plus investment timeframe that the industry infrastructure requires poses an interesting management challenge.

## Blurring of roles

In the meantime, the lack of confidence that prevails in the aftermath of the financial crisis means many institutional clients are wary of consolidating all their stock holdings with a single global player, however big that player is. As a result we are seeing other providers in the infrastructure space receiving unprecedented requests to provide contingency custody services from institutions looking to diversify risk. This is clear evidence that the ‘squeeze’ between forces for and against change is fertilising the seeds of innovation. For the nimble and quick witted in the post trade arena, these circumstances offer opportunities to climb up the value chain.

Perhaps nowhere is this evidenced more than in the field of ICSDs. Banks need to sweat their capital harder than ever and therefore efficiently managing pools of collateral is becoming a key focus. ICSDs are stepping in to manage the movement of collateral margins between the accounts of the banks and their clients. Typically managed through tri-party collateral management services, these new services monitor and transfer stocks held in safekeeping on receipt of client instructions. In time, the ICSDs might see themselves inch even further up the value chain and manage the valuation process too, calculating the margins on behalf of the banks.

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Clearing Houses too, unique in their position in the value chain, have identified opportunities for innovation. Because they are situated in the middle of the value chain between execution and settlement, they have visibility into the issues facing all participants and can develop standardised products that can boost liquidity and make markets more efficient. There is considerable focus on the repo market right now, and one offering in development responds to the market's desire for capital efficiency by developing a product that enables a bank to receive term economic exposure but with the balance sheet utilisation of an overnight trade. The introduction of standardised products like this will increase the opportunity to trade – but will also lead to major transaction volume increases over time.

Yet while infrastructure providers may be very keen to move into new products and market segments, they have to remain mindful of their core purpose to deliver a controlled and efficient infrastructure. There is a myriad of good ideas, but once again there are opposing forces at play that act as a barrier to change. Any innovation may involve introducing unacceptable additional risk to the infrastructure and, if done properly, will require significant amounts of time and money. So, in an increasingly complex and rapidly changing market, providers must be confident that the regulatory goalposts won't have moved by the time they have launched a new offering.

## Fixed Income is not the new Equities

What is absolutely clear is that fixed income in Europe is set to lift off, and that, despite some of the barriers, significant change is inevitable. Looking to the future we will see a blurring of roles at the front end of the value chain as the large broker dealers lose market share. The execution space will become increasingly fragmented as the markets evolve to the new dynamics of regulation and greater aversion to risk, combined with new participants entering the debt markets to meet their funding needs.

The post trade infrastructure will consolidate but also blur. We will see the demise of the domestic infrastructures as greater inter-operability becomes reality. Across asset classes, there will be further adoption of central clearing models with the accompanying challenge of on-boarding new and smaller market participants. The winners in the infrastructure businesses will be those firms that innovate to deliver solutions to these changes and those that further diversify into areas such as collateral management and securities financing. In five years time, we envisage both ICSDs and outsourced service providers having taken on many of the functions traditionally provided by a prime broker.

There will also be unpredictable responses and unintended consequences that are harder to predict. It is often suggested that fixed income will adopt the characteristics and trends played out in equity markets, but that belies the complexity and fragmentation of OTC fixed income markets that have evolved over decades. Instead, perhaps we should look to further parallels with the FX industry, which itself emerged from the shadows some years ago. From being an important but functional institutional product, FX became an asset class in its own right, attracting large numbers of institutional and then retail investors - which we might well see now in fixed income. This volume increase – with the associated capacity constraints and technology challenges – has defined the FX industry in recent years. Perhaps the next challenge that fixed income could face will be how the infrastructure can cope with the processing strain.

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## Ideas Without Limits

This white paper is part of Ideas Without Limits, a programme designed to help financial services firms and investment professionals identify trends, enhance operations and grow revenue.

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This article was commissioned by Pershing and produced by Investance. The findings are based on industry research and 15 detailed interviews conducted by Investance.

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