Market utilities: useless or useful?

It is only a matter of time before one of the larger international service providers realises that service delivery to the retail broker-dealer space sector is not as complicated as many believe, says Denis Orrock of GBST Capital Markets

In recent years, a range of initiatives have been proposed by organisations looking to consolidate back-office processing functions through the establishment of market utilities.

These initiatives have been pursued by groups of member firms looking to establish what can only be loosely called cooperatives. Typically, the initiatives have been born from a group of independent broker-dealers collectively looking to find a way to reduce overall costs through some form of mutualisation. Alternatively, they have been driven by a local exchange itself looking to support their domestic brokers through the establishment of some form of consortium.The driving force behind these initiatives has typically been the need to support the smaller independent broker-dealer networks that are looking for some form of assistance in order to remain in business.

There are numerous reasons why these market participants are exploring business models to support their capabilities, but the big-ticket items are the obvious ones:

- Reduced revenue as brokerage fees and charges have come under scrutiny and price pressure;
- Increases in the costs associated with regulatory compliance and prudential supervision; and
- Increased capital and liquidity requirements.

These factors, together with an ever changing technology landscape, make the outlook for many smaller independent and bank-aligned broker-dealers globally appear more than just challenging—some may describe the future state as being grim.

In evaluating these proposals, questions about the drivers for outsourcing and the functions they are looking to mutualise must be addressed. In addition, the second part of the question is who will assist the new entity to implement international best-practice operational models?

The main driver for outsourcing is obvious: they wish to outsource whatever functions can be performed centrally and which result in changing fixed costs into variable costs that align their expenses with their revenue streams. To be successful, the unit cost of processing must be lower than under the existing model.

The answer to the second part is more complicated. If it means outsourcing to a firm or cooperative that has been established by 'cherry picking' staff from members of the group and which relies on the use of existing technology, it is unlikely that the operational model will be sufficiently different to deliver the productivity improvements required. While this approach may deliver some benefits through increased volume and lower fixed costs per unit, it will still retain many of the inefficiencies and constraints of the existing model.

To deliver the lower unit costs required by participants while at the same time delivering a sustainable ongoing business in its own right requires a fundamental improvement in processing design and execution efficiency.

The establishment of a cooperative or market utility will, of course, go a long way in a market to 'soft launch' the concept of outsourcing, be it on an agency/account operator or third party-clearing (TPC) basis. It is, however, unlikely that the operation will be sustainable over the longer term unless it delivers fundamentally more efficient processing to the extent required to deliver lower unit costs to users, while also generating the revenue required to sustain the new business.

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If the sole objective of the market utility is to offer the lowest possible per unit processing cost to the members of the market utility, then this objective will starve the utility of funds and sustainable growth opportunities will not be able to be pursued.

The perpetuation of existing processing models, together with the single objective of lower costs, is an unsustainable business model that ultimately will not generate the cash reserves or appetite to invest in the level of technology and intellectual property required to make the business sustainable over the longer term.

The absence of a truly competitive marketplace among third-party clearing or administration providers is resulting in constrained innovation as a race to the bottom takes hold on costs and investment capital. If the rate of innovation is low, those parties that outsource to marginal service providers will fall behind their international counterparts as flexible and innovative services are not on offer and the entities cannot afford to implement them.

A market utility that has emerged from the collective initiative of smaller market participants must establish itself as a profitable business in its own right. While the intellectual theory supporting a coop style operation has merit, the initiative will only thrive if the desire is to create a truly world-class participant that provides value to the consortium members through efficient processing and capital management, and has sustainable profitability targets that will create an asset with external market value. Put simply, the utility needs to foster its own ambition and seek to cut the ties to the collective mothership early in its lifecycle.

Ideally, market participants should be free to choose between competitive service providers as a means of ensuring that market participants are obtaining the best fee for service and that innovation in service and technology provision will be forthcoming.

The fundamental problem is that this is not the reality. Many initiatives have failed to get off the ground due to a lack of investment from the sponsoring participants and a lack of commitment from the broker community to utilise the services while the initiative is in its infancy. It is also the case that many of the existing clearers or custodians providing outsourced processing do not see the retail stockbroking segment as core to their business—this results in this segment of the industry being largely un-serviced.

It is only a matter of time before one of the larger international service providers realises that service delivery to the retail broker-dealer space sector is not as complicated as popular opinion would have one believe. The technology available to them today can significantly simplify the service delivery. Servicing this retail broker-dealer segment has the potential to add significantly to the revenue stream for many of the custodians and clearers that already operate in these markets but currently limit their service to institutional brokers. The continued growth within emerging markets dictate that a healthy retail wealth industry will follow, so service providers need to be looking forward at the market of tomorrow and not trying to solve the market proposition of today.

This lack of options for retail broker-dealers leaves a hole that needs to be filled. If history is any indication, someone will fill the need with a solution and make a profit from it. The bigger question is who will step in to fill the void and deliver a cost-effective solution and when will they do it? Ideally, this will happen before too many retail brokers are driven out of the market they operate in. **AST**

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