An old game with new rules: Creating value in today's securities industry

Capital markets players are today confronted with the most severe operating environment in a generation. Global economic and political uncertainty, a new-issue drought and increasingly demanding customers are hitting firms bloated by a decade of unprecedented growth – leaving them to find their footing on an increasingly choppy and ever-shifting playing field. Long-term winners will carefully marshal their resources today, while preparing for the inevitable upturn. This will involve revamping business models to take advantage of the new capital markets environment, where the only constant will be change.

By Daniel Latimore, Vikram Lund, Ian Watson, John Raposo and Greg Robinson

Contents

New technologies are revolutionizing how securities firms operate, enabling these businesses to appropriately integrate legacy and new applications … provide faster, easier access to data … outsource specific processes … lower the price of computation … and improve their ability to derive usable insights from vast stores of information.

Introduction

During a decade of unprecedented growth, especially notable in the U.S., securities firms– investment banks, broker-dealers and commercial banks alike – enjoyed an idyllic period, a time when equity market capitalization tripled, annual global equity volume grew by a factor of ten, and industry revenues and employee compensation quadrupled.[1] Yet, behind the scenes, the forces of change and the consequences of growth were taking their toll. Consider that in 1976, close to half of New York Stock Exchange members' revenue came from commissions. Today, that number has dropped to 13 percent,[2] replaced by "Other Securities Related Income," principally interest income on securities held for trading, but also private-placement and M&A activity, as well as underwriting and advisory services. Firms that invested in new markets and products to increase top-line results are paying the price for assuming that revenues would naturally lead to increased profits and larger market share – a strategy that offered little protection from recent market downturns. The effects of technology, regulation and globalization are only exacerbating what has become a highly volatile, dynamic operating environment populated by a new generation of freshly empowered customers.

When one makes year-to-year comparisons, the current level of business looks dire; however, placed in the larger context of the last decade's growth, it's actually quite reasonable. Yet, many firms, not wanting to be left unprepared to capture new business, staffed up a for a growth trajectory that never materialized, and are now having to scale back.

As financial companies work to streamline their businesses and position themselves for future growth, speed, flexibility and flawless execution will be critical to long-term success. Firms that flourish will design their strategies with three factors firmly in mind: the marketplace, the competition and the client.

A dynamic, unpredictable operating environment

Although the financial services industry has long been familiar with the demands of technology, globalization and regulatory requirements, changes in these areas continue to accelerate — forcing firms to transform how they do business.

Technology is essentially changing how investors buy and sell financial instruments, and how organizations integrate and manage their core business processes. Traditionally, technology was employed to make existing processes more efficient; today, buyers and sellers can interact directly and immediately using standardized electronic channels. This is fundamentally altering the nature of relationships involved in financial transactions — and a system that has been left essentially intact since the Buttonwood Agreement in 1792. Information, once the principal competitive advantage of sellers and one of the primary sources of value they brought to the table, is now readily and cheaply available across geographies and product lines. This shift has left sell-side firms scrambling to determine where they can add (and charge for) more value.

Globalization continues to accelerate — compelling global-minded securities companies to extend their reach, solidify their position in the world's major markets, and adapt to the demands of global investors and issuers. These objectives are typically achieved through cross-industry and cross-country M&A activity and, increasingly, through partnerships.

Regulatory changes — both deregulation and reregulation — continue to create new opportunities and foreclose existing ones. Each new scandal or crisis in a country or region prompts calls for changes to the regulatory environment. While some of these efforts are successful, others prove fruitless. Spurred by globalization and monetary harmonization, global regulators continue to seek ways to better oversee an increasingly interdependent, international trading community.

In 2001, the U.S. securities industry experienced a decline of 31200 jobs (a 4 percent reduction).[3]

Trends and directions

The present state of the industry has compelled firms to adopt short-term survival tactics. Because the majority of securities companies' costs structure is related to compensation – much of which is "incentive-based" or variable – businesses have been forced to reduce bonuses and lay off employees. More dramatically, many companies have eliminated under-performing segments of their business, or pulled out of geographical areas that are not carrying their weight. For example, Merrill Lynch downsized its retail operations in Canada, Japan and Australia in order to balance the size of those businesses with market opportunity.[4,5] Other companies have decided to limit their services to a particular customer set or need, such as institutional investors and wealthy individuals (for example, Credit Suisse First Boston[6]). Still other firms, such as Prudential, are focusing their businesses on providing independent, impartial research to their investing clients, forsaking investment banking entirely.[7]

Sluggish growth rates have accelerated consolidation – a situation that is expected to reduce the number of NYSE member firms by 15 percent in 2003.[8] This has presented an opportunity for companies to step back and realistically assess their capabilities – a situation that often brings about changes in location, products and services, or customer sets. Mid-tier firms are moving to either end of the spectrum – a trend that is creating a barbell-shaped industry structure with global sell-side companies on one end and niche players, focused on specific products, clients or geographies, on the other. A number of regional investment banks have either merged with or been acquired by large, global organizations; other firms have chosen to concentrate their efforts in specific areas, like advisory services. Whatever path they follow, those who thrive will learn to be both prudent and proactive in the face of the inevitable market upswing.

Margin compression, decimal pricing, scale and direct access: Facing the consequences

There are other, more subtle issues that come into play in today's marketplace. Though by now familiar, these considerations continue to challenge the industry, and will significantly impact how firms operate in the future:

- *Margin compression* – With the elimination of fixed commissions in New York a quarter-century ago, commissions began to decline steadily. While firms have made strides in diversifying their portfolios and revenue mix, the role of commissions in the overall revenue equation has been relegated to helping cover fixed costs, simply breaking even on individual transactions, or both.

- *Decimal pricing* has continued to erode margins in the U.S., intruding on the traditional and profitable practice of market-making and reducing the average bid-ask spread on Nasdaq stock from 11 cents in January 2001 to four cents in December.[9, 10] The very advantage that decimalization affords – the ability to price securities in the same way across world financial markets – has taken its toll on U.S.-based firms that are not used to competing in an environment of tiny spreads.
- *Scale* – Today, bigger is better, not only when it comes to global reach and range, but also in terms of a business's ability to supply its own capital to satisfy the requirements of issuers. Global scale offers protection by diversifying exposure; product scale provides the opportunity to spread fixed costs. The role that technology plays in helping companies integrate and consolidate their enterprise, manage dispersed employees and customers, and deliver products and services worldwide cannot be overestimated. What was once considered impossible, or at the very least economically impractical, has become imminently attainable – food for thought for firms of every shape and size.
- *Direct access* – Thanks to alternative trading systems (ATSs), including electronic commerce networks (ECNs), institutional investors and issuers can now trade directly with one another. Yet, while the buy-side can reap benefits by bypassing the sell-side, problems can arise in terms of time, expertise and value – an issue that securities firms have addressed by developing their own systems or investing in direct-access mechanisms. The sell-side faces the threat of disintermediation, at least for the moment, in small, less-complex trades – the mainstay of a firm's easy, relatively low-risk trading profits. To date, direct access has made the most inroads in futures and equities markets. Sell-side companies will continue to maintain their edge in conducting large or illiquid transactions that call for considerable expertise and a high level of capital commitment. Even though fixed-income investors have been less inclined toward direct access, it is gaining ground among all constituents. Although the number of U.S. fixed-income electronic trading platforms increased from 11 in 1997 to 68 in 2000, 2001 ushered in a wave of consolidation, leaving 49 trading platforms at year end. Meanwhile, European ECNs – which numbered only 5 in 2000 – continued to grow, totaling 24 by the end of 2001.[12] Lower costs, greater anonymity and larger pools of liquidity are enticing advantages to potential ATS participants. If the role of the middleman is to survive, those companies will have to add far more value than simply matching buyers with sellers – a fact now evident every day.

"For starters, finance is better suited to the capabilities of the Internet … it deals in information, not goods. Companies don't have the cost of shipping books, dog food or sofas around the country … there's nothing a customer has to see or feel." *Michael Hodes, Goldman, Sachs & Co.*[11]

The majority of ECNs in the U.S. cater to the needs of the institutional market. Europe has close to 20 equity ATSs in place, but is impeded by the complexities of multiple clearing systems and numerous trading barriers. Currently, European ECNs are, for the most part, devoted to providing value-added services rather than direct access. Japan, on the other hand, has been slow to adopt equity ATSs; to date, the country has only four systems.[13]

More power to the buyer

Traditionally, sell-side firms reaped the benefits of information asymmetry with respect to their buy-side clients; they had more raw data, plus a continuous flow of trading data from the transactions they crossed. Buyers were limited by what sellers wanted them to know, plus whatever information they could glean from the dealer community. This resulted in a huge advantage – and a prime source of profit – for the sell-side.

Although securities firms have made significant investments in building and maintaining their IT infrastructures, few have viewed these assets as a way to add real business value. Today's technologies are changing that perception – significantly reducing the cost of gathering, sorting, distributing and exchanging market information. This, in turn, has closed the information gap and realigned the balance of power. Although technologies offer dramatic advantages in terms of speed and pricing, the need for value-added services still exists. The shape of these services, however, has changed.

Today's better-informed and increasingly powerful clients want service on *their* terms. They have access to data, they know what things cost and they don't mind paying for real value. No longer proprietary assets, unfiltered information and research are now readily available through a host of channels. What clients are really looking for is *counsel* – a now-critical ingredient that enables firms to correctly assess a customer's alternatives in the context of the client's goals and market conditions, then use that knowledge to recommend both short- and long-term strategies.

Clearly, sell-side companies will have to work harder than ever if they are to succeed in a world where information has become a commodity and success rests on the ability to effectively dissect, analyze and filter data from any number of sources, in realtime. At the same time, firms will have to fortify their portfolio of customer relationships by assessing the profitability of institutional clients, then deciding how best to serve them. In conversations with a number of buy-side firms, teams from the IBM Institute for Business Value found that institutional investors prefer firms that take a keen interest in their specific needs, then recommend strategies tailored to the client's specific situations. Simply stated, the buy-side doesn't want to waste its time with a salesperson who is peddling whatever happens to be "on special" that day. As rational capitalists, both the buy-side and sell-side are looking for mutually beneficial relationships. If the advantages of the relationship aren't commensurate with the effort required, one or the other party might have to go.

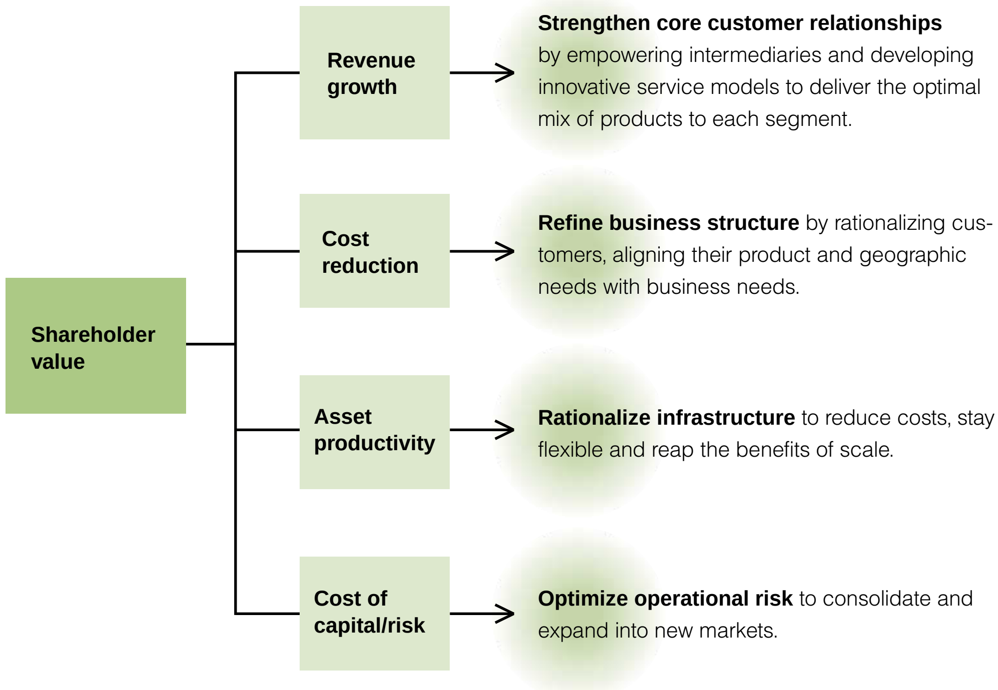

Figure 1. There are specific opportunities associated with each of the four fundamental levers for creating shareholder value.

Unbundling the business: The separation of advice and execution

Historically, sell-side firms bundled order-execution, advisory and research services for their institutional clients. This resulted in a win-win proposition, because buy-side companies (with the exception of the very large firms) typically lacked the internal capabilities to provide the depth of research offered by Wall Street, and could, in essence, outsource this capability by turning to their trading partners on the sell-side. Sellers benefited from having research lead to committed order flow (guaranteed by the provision of "soft dollars") and the opportunity to win lucrative underwriting assignments.

The established practice of bundling products and services is now evolving in response to four major forces: investment performance, buy-side demand, research marginalization and regulatory changes. These issues are gradually changing how firms market and deliver their offerings – a shift that will dramatically alter the economic framework upon which securities companies have traditionally bought and sold products and services.

A number of studies confirm that bundled securities products come at a higher price than stand-alone transactions. Bundled offerings (often paid for by soft dollars) carry higher *explicit* costs (trading commissions) as well as greater *implicit* costs (in terms of market impact and opportunity). It's no wonder, then, that buy-side firms are increasingly attracted to the separation of advice and execution – the value provided by the research that they receive is outweighed by the cost, whether paid for by soft dollars or not. One only has to observe the amount of stand-alone transactions being performed by execution-only brokers and through ECNs to understand the significance of this trend. The demand for stand-alone research is underscored by a new crop of pure research firms and the tendency of large buy-side companies to rely on their own research capabilities or commission custom research from independent third parties (often business or technical resources, rather than financial experts). These inclinations pose clear threats to already compromised profit margins.

Goldman Sachs, long known for its high-touch services, now offers its customers access to simple transactions through REDIPlus, the firm's ECN. Brown Brothers Harriman, which traditionally bundled sell-side research with trade execution service for buy-side firms, decided that it could not offset the high costs of producing research with underwriting income, and subsequently discontinued that part of its business.[14]

To work through this challenge, sell-side companies will have to consider breaking out the costs of trading, advisory and research services. This will involve changing the status of offerings – from bundled services to individual items priced according to the value they provide to the buy-side and the cost they incur on the sell-side. And if the perceived value doesn't match the cost to produce, some services will no longer be offered.

In the U.S., Regulation FD authorized the release of company information to all constituents. In the U.K., the controversial Myners Report (although not enacted as regulation) advocated an end to soft-dollar commissions, and has raised the profile of soft-dollar practices.

Under these circumstances, sell-side firms must seek ways to enhance their offerings – moving from *disseminating* information to *interpreting* it (without any perceived bias) to add more collective benefits for the client and, ultimately, the company.

Customer value: Creating a mutually beneficial proposition

In today's climate, securities companies must reexamine who they want to serve, and how. Constrained by the economic climate and an environment filled with cautious investors and anxious competitors, sell-side firms are digging in. In the face of declining growth, these companies are rightly focusing on the levers that can today improve the bottom-line: strategies for reducing costs and increasing efficiencies. This represents a major shift – but needed prudence.

Many businesses are starting to segment their customer base to gain better insight into clients' needs and profit potential, as well as the overall value (direct and indirect) of each *firm-wide relationship* (as opposed to gauging value based only on each separate *account-level relationship*). By taking this approach, these organizations can develop offering portfolios that better address the requirements of clients and, ultimately, contribute more to the bottom line. Clients will benefit from more-focused coverage because the salespeople assigned to their account are expected to demonstrate a more-comprehensive understanding of their clients' needs *and* their market – thereby providing more-effective counsel.

Assessing service models

Not surprisingly, sell-firms are examining their service models and exploring new approaches. The one that they ultimately choose will depend on the cost to serve versus the value-add to clients. It remains to be seen which model will prevail.

In the past, many firms assigned individual accounts according to, say, geography. This "atomistic" approach implies that the person servicing those clients can understand each client's entire portfolio. As products proliferate and grow more complex, the need for a deeper understanding of these offerings is prompting sellers to explore other models. More recently, several firms have started to group sales personnel according to customer segments. For example, rather than being responsible for a thrift, a hedge fund and a pension fund in Dallas, a salesperson might now cover hedge funds in Dallas, Houston and Denver. One remaining drawback, however, is that no one is directly responsible for overseeing the entire investor relationship.

Today, a number of firms are moving toward a *relationship model*, in which a company assigns a primary relationship manager to assure that everything is running smoothly and that salespeople are meeting clients' expectations. Because adding a relationship manager increases costs, companies will have to determine if this improvement in client service can ultimately be justified.

Whatever model they elect to deploy, successful sell-side companies must develop an IT infrastructure to support the needs of the firm – an environment that can step up to new requirements in every area of the ever-changing business: marketing, selling, counseling, research and service alike.

Four steps to creating shareholder value

Typically, companies build value in four ways: growing revenue, reducing costs, increasing asset productivity and managing risk. The IBM Institute for Business Value recommends that firms consider taking specific actions to help achieve these goals.

Objective: ***Grow revenue***

Action: *Strengthen core relationships by empowering salespeople and developing innovative service models to deliver the optimal mix of products to each customer segment.*

Simply put, get to know each of your customers better so you can tailor advice and offerings to their specific requirements – in a way that earns trust, adds value and maximizes the relationship.

Objective: ***Reduce costs***

Action: *Refine the business structure by altering coverage models and redefining service levels to better align with customers' product and geographic needs, as well as with the needs of the business.*

Objective: ***Increase asset productivity***

Action: *Rationalize the infrastructure.*

Today, integration is everything, and there is much to learn from the mistakes of the past. For years, companies poured money into their IT environments – giving their lines of business free reign when it came to purchasing, developing and deploying those systems. Understandably, this has left many firms with incompatible platforms, disparate databases and redundant processes.

Objective: ***Manage operational risk***

Action: *While most large firms comprehend financial risk, many fall short in assessing their operational risk. Nonetheless, the latter is critical to better controlling exposures when entering new markets, presenting new offerings and mitigating risk to current operations.*

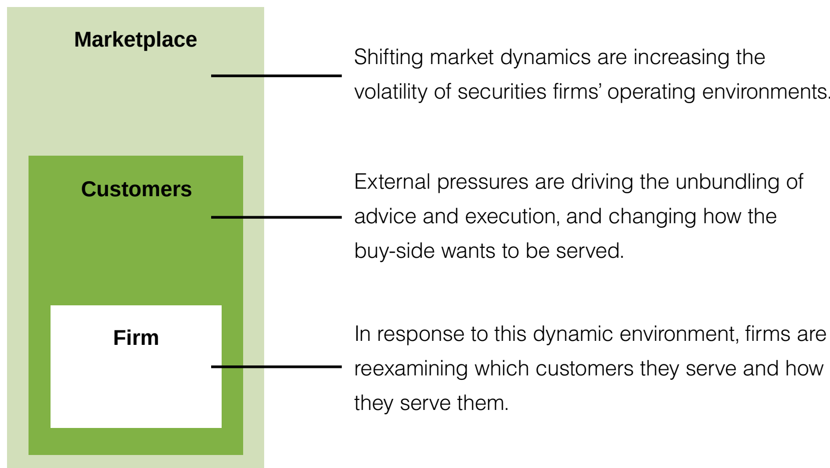

Figure 2. To respond to increasingly dynamic and challenging securities markets, firms must understand and address three areas.

What is your company doing?

Securities firms can build sustainable advantage by considering specific actions in each of the four areas:

Strengthen core customer relationships

- Assess the overall profitability of each customer to determine the appropriate service and delivery model.
- Create a holistic understanding of each customer's situation to anticipate future trading and investment banking needs.
- Think about pursuing a needs-based analysis to understand the optimal product mix for each customer segment.
- Build smart applications and a flexible infrastructure to push ideas to client intermediaries on a realtime basis.

Refine the business structure

- Use client-related data to help decide whether to jettison or restructure unprofitable or nonstrategic customer relationships.
- Rationalize existing lines of business to determine what units add substantially to your firm's overall value proposition and profitability.
- Determine where key cross-business interdependencies exist before finalizing retrenchment decisions.
- Decide which functional elements are core, and leverage technology to drive down operational costs
- Outsource non-core operations as necessary.

Rationalize the infrastructure

- Convert from proprietary, client-based systems to open, universal platforms
- Build an infrastructure that is flexible and ready to respond to shifting business needs
- Where appropriate, in-source core capabilities for other securities firms
- Eliminate redundant platforms, systems and projects. Although this action may seem self-evident, remember that it can pose political challenges.

Manage operational risk

- Supervise risk and control
- Install process monitoring and surveillance
- Increase infrastructure reliability and resilience
- Improve process efficiency
- Optimize business continuity and recoverability measures.

Get started now

The IBM Institute for Business Value comprises veteran industry consultants ready to help financial services firms create and sustain value in every area of their business. To explore how we can help your organization, contact us at *bva@us.ibm.com*. To browse through other resources for business executives, visit our Web site at:

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