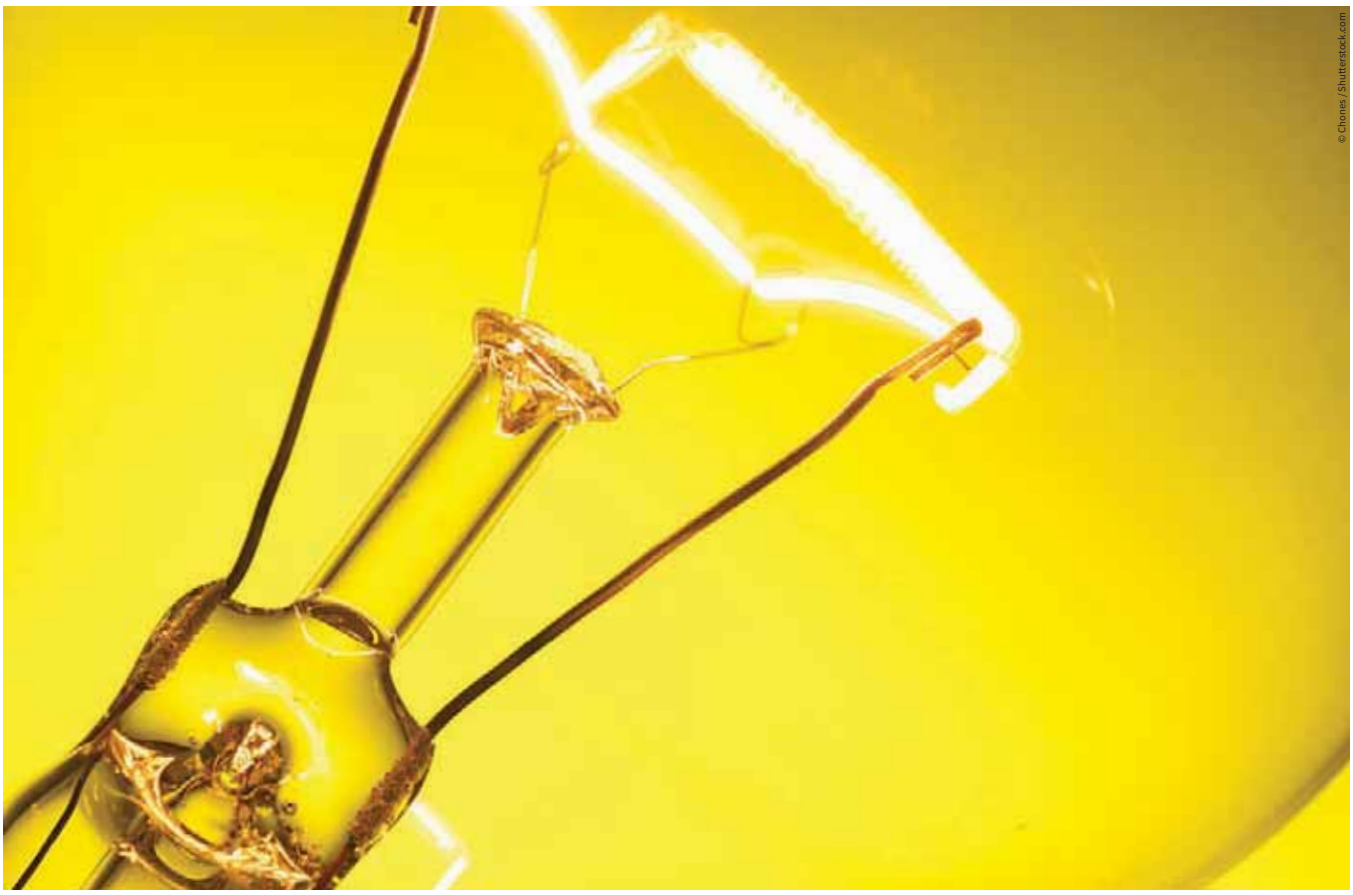


Compliance gives way to reliance

Adopting third-party solutions to comply with regulatory reforms such as Dodd-Frank and EMIR has become commonplace in the financial industry. Leading banks are now placing their trust in the management of many back and middle office functions led by fintech companies who are transforming the risk management landscape, writes FX-MM's Neil Dennis.

These are the days of lower returns for banks. The risk environment for financial institutions is polluted with negative interest rates, central banks engaging in quantitative easing and stifling regulatory requirements that are raising operating costs, and putting pressure on balance sheets and profit margins.

Facing such pressures, the financial industry has traditionally focused on reducing costs. Following such cuts made in the aftermath of the financial crisis, however, many financial services companies are already leaner beasts. So where is the fat from which to cut now?

In part, banks' hands were forced by regulatory rulings from Frank-Dodd in the US and the European Securities and Markets Authority, and many financial companies have been able to rationalise operations in their middle and back offices. This is a process that appears to be gathering momentum as banks employ an industry subsector of financial technology – or fintech – companies that are fast becoming known as financial utilities.

The most significant savings can be achieved through the 'mutualisation' of many common services that all banks provide – to a greater or lesser degree – in house at their own expense. Broadridge Financial Solutions explained the concept of mutualisation and financial utility in its white paper published last year[1]: "We believe that by mutualising highly standardised trade processing functions

through a utility model, participants will benefit from economies of scale and network effects."

Matthew Stauffer, Chief Executive Officer of Clarient Global LLC, which developed a platform along with co-founders Barclays, Credit Suisse, JPMorgan, State Street, Goldman Sachs and Bank of New York nearly two years ago, also promotes the utility model.

"Our primary objective is to reduce the amount of time that firms are spending performing non-strategic, highly-redundant activities with a significant amount of manual processing and bilateral back-and-forth communications. These activities lend themselves to error and delays in the institution's overall business processes."

He says the relationship between his company and its founding banks acknowledges the opportunity to mutualise much of the cost and the risk involved in the post trade environment.


Matthew Stauffer
Clarient Global LLC

"Clarient is not a pure operational play or pure technology play, but is a utility model which brings technology, operations and content together to help alleviate some of these challenges."

Joseph Turso, Vice President of Product Marketing at SmartStream Reference Data Utility, adds: "When you look at the financial services industry and especially reference data – so much of this can be mutualised because when you look at the banks, they all do a lot of the same things when it comes to managing data – they have a lot of the same requirements in terms of data. So if everybody is essentially doing the same things, why not do it once, do it in the best practices, and do it the most cost efficiently? This is the utility model and several entities can benefit from performing a task just once."

The most significant savings can be achieved through the 'mutualisation' of many common services that all banks provide – to a greater or lesser degree – in house at their own expense

Post trade processing costs

Broadridge estimates the financial industry currently spends up to $24bn a year on core post-trade processing and other functions, with $6bn to $9bn of this in highly standardised asset classes.

"The majority of cost savings comes around the act of sourcing content – underlying reference data and documentation – standardising that content, validating that it is accurate, then building it into a model from which judgment can be taken," says Stauffer at Clarient.

"This leads to a better experience for institutions because they are only engaging with one, or a limited number, of touch points rather than with every counterparty they do business with."

Most financial utility service providers believe they can save their clients up to 40% of the costs of performing these functions in house.

"If you look at how reference data is used – across the front, middle and back office – it is used to support trading, to help with risk management, as well as aiding settlement and clearing functions. Reference data is pervasive throughout the whole organisation. So what we're trying to do is reduce the complexity from a technology point of view," says Turso at SmartStream RDU.

He adds: "On the operational side, banks are looking for a potential 20-40% cost saving by using the utility model."


Joseph Turso
SmartStream

Raghav Nandagopal, Head of Strategy, Business Development and Product Strategy for the Global Technology and Operations division of Broadridge, says: "Banks spend between $17bn and $24bn on trade processing – this includes the reconciliation activities, reference data, expense management, trade corporate actions, tax, regulatory reporting and client life-cycle management.

"If banks were to employ the utility model, they could generate savings of up to 40%, which could enable the industry to save around $4bn a year. So if you are a tier-one bank, this means you could save approximately $100m to $300m annually.

"In addition to the potential savings, a utility model enables banks

to benefit from increased overall productivity and innovation, stronger regulatory compliance and risk management and at the highest level, allows them to create a more efficient operation that allows for reinvestment in other, more strategic areas."

Long time coming

It seems odd that the utility model – taken for granted for providing essential services to households around the globe, and long established also in many industrial activities like mining and oil production – is only just starting to take a grip on financial services. Was there resistance to the model?

Probably so. Raghav at Broadridge explains that, in pre-crisis days, the complexities of post trade were seen as a unique set of activities that could not be separated from a bank's operations – 'differentiating functions' – as opposed to 'non-differentiating functions' for which common solutions may be found.

"Also, there was a tremendous amount of investment that went into these operations, especially from a regulatory point of view: hundreds of millions of dollars that these banks invested on their own."

That is a massive investment to simply take for granted and perhaps even cast aside for a model that was, up to that point, largely unproven.

Turso at SmartStream RDU explains that the concept of a financial utility model has been around for a while, but coming out of the 2008 crisis – just as regulators were mandating financial companies to better understand their data – banks were facing a dilemma.

"They were being asked to invest more in their data, while at the same time being compelled to reduce costs – these are conflicting priorities. So collectively, as an industry, they have pulled together to help solve these problems with the utility model."

Raghav Nandagopal
Broadridge

Indeed, the proliferation of large data warehouses at banking organisations was proving costly, both in setting up and maintaining, and in reconciling inconsistent data coming from different data marts.

"So what the utility model provides is a much more cost effective approach than taking all your data marts and trying to create a single, consolidated data mart – which is costly," continues Turso. "It's been tried many times in the industry, and it is a multi-year, multi-million dollar project."

> *If banks were to employ the utility model, they could generate savings of up to 40%, which could enable the industry to save around $4bn a year*

Risks and criticisms

Another reason why the financial utility model did not move more quickly may have something to do with the risks involved in converting from in-house systems and software to a third party provider. The major banks were careful here, and the top platforms they are now using around the globe have all been developed in partnership.

Matthew Stauffer at Clarient says: "We structured our information security and data privacy controls with the input, governance and oversight of the chief information security officers of all of our founding members."

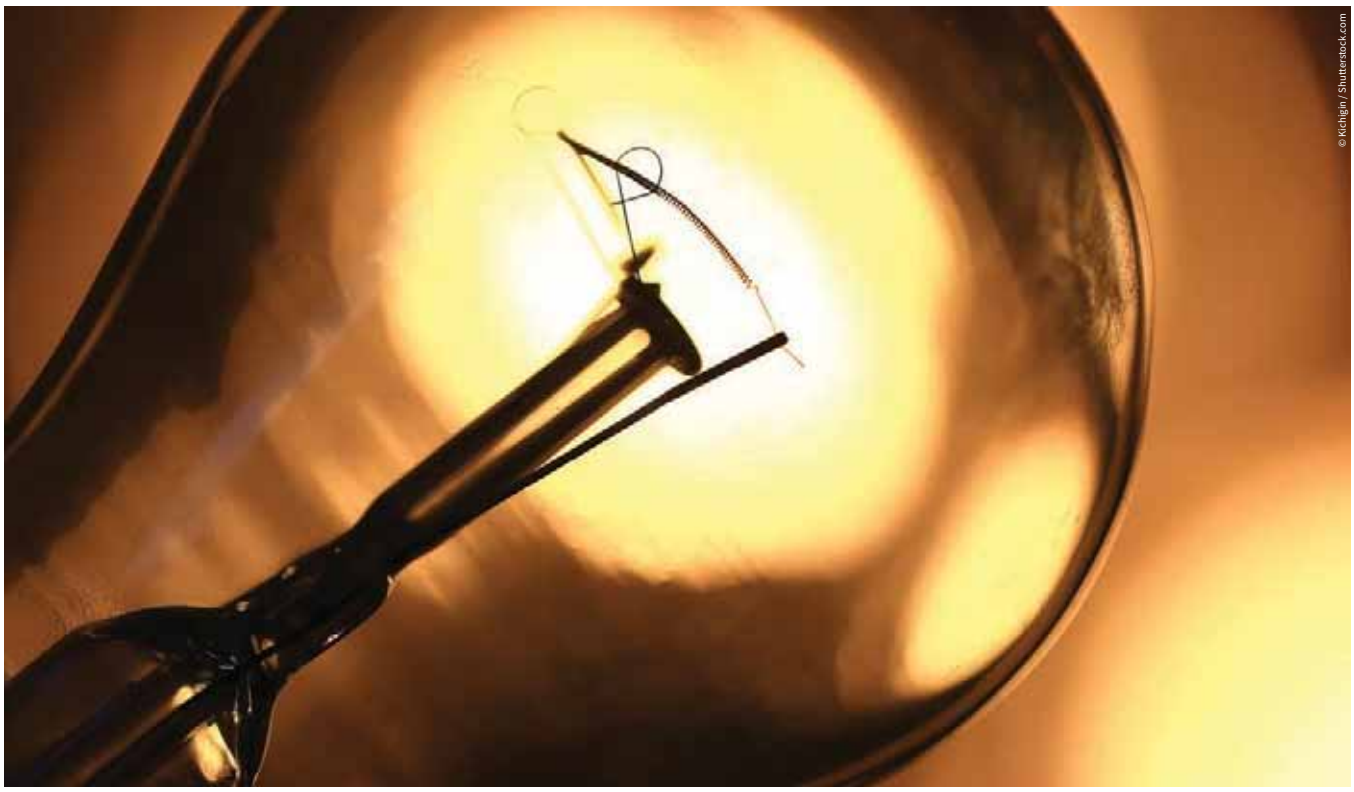
He adds: "For financial institutions to use our platform we have to be equal to, or better than what their processes are today. The way our technology and operational platforms have been built provide a best-in-class control framework."

Raghav at Broadridge warns that converting from in house solutions to a multi-tenant utility platform is complex and expensive – "typically it will take anywhere from two to three years to perform that specific conversion," he says.

He is confident that the utility model will actually help firms to reduce risk, but notes that the success of this process will hinge on operational excellence – in terms of risk data management, datascope management and systemic risk management.

For example, a phased implementation approach will have a higher probability of success than a 'Big Bang' conversion approach.

"We are all pretty conscious of the risks," says Turso at SmartStream RDU. "Utilities are becoming an extension of the back



offices at the bank and as a result we need to be completely compliant with the banks' operations risk models."

Does this mean that as utilities become 'an extension' of banks' back offices there is also the risk of over-reliance – that financial industry chief executives take their eyes off back office operations?

"Not at all," says Turso. "We're so tightly coupled to our clients' businesses, I don't see anyone taking their eye off us. I see further scrutiny over time."

There are also some concerns that the model could ultimately restrict competition between banks and result in increased consumer prices.

> *For financial institutions to use our platform we have to be equal to, or better than what their processes are today. The way our technology and operational platforms have been built provide a best-in-class control framework*

Matthew Stauffer does not agree, however. He believes that through mutualisation financial utilities can "continue to drive down costs for clients, and therefore for end institutions and end investors, allowing banks, broker-dealers and investment managers to focus on creating value and wealth for their clients".

The way forward

There is much excitement in the industry about the future for financial utilities. Turso believes banks will further adapt to this model because the challenges of meeting regulatory requirements and cost reductions are not being found down traditional paths.

"This isn't being driven by the vendor side," he says. "It is bank-driven – for the first time in this industry, the walls are being taken down and banks are collectively talking about how to manage their reference data and sharing information about best practices, and they are not looking at this as gaining a competitive edge anymore. That is terribly exciting for someone like me who has been in the industry for 25 years as this is a real game changer for the industry."

Stauffer at Clarient is certain the industry has a unique opportunity to further leverage the utility infrastructure.

"I don't think it has been pushed as far as it can be, and believe we are still a long way from a point of over-reliance. If anything, the bilateral manual alternative has a higher risk profile," he says.

Raghav at Broadridge agrees. "This is a tremendous opportunity for the industry to drive efficiency, and accelerate the transformation of the operating model."

Indeed, in a report by Finextra Research that was published in February[2], a survey of 102 financial services professionals from 69 institutions across 26 countries showed as many as 73% were prepared to use the utility model for data management. The banks and other institutions polled said they believed the third party utility approach helped "cut costs, cope with variable volumes and achieve predictable service and quality levels".

While growth has been slow and hard earned for banks in the years that have followed the financial crisis, third-party solutions to regulatory mandates in the financial sector have driven, and look like continuing to drive growth in the fintech industry for some years.

References

1. *Charting a path to post-trade utility*, by Broadridge
2. *What makes utilities useful?* by Finextra and Capco

For further information: **www.fx-mm.com**

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