Point of View

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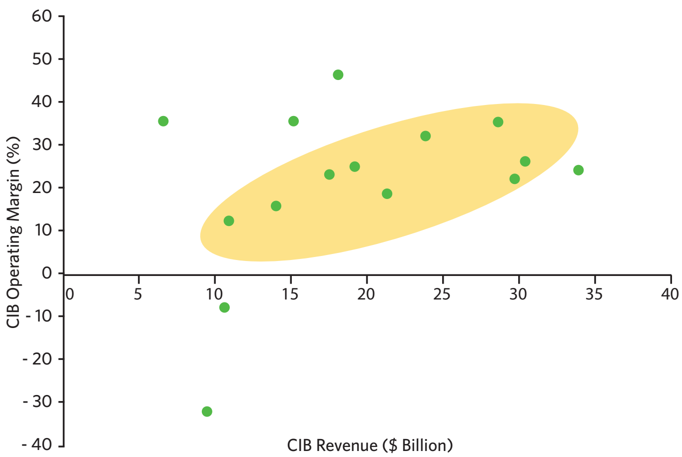
Forming an industry-wide post-trade shared services utility: not an "all or nothing" play

Tier 1 banks have an edge over smaller rivals: Their greater scale offers a near-unbeatable cost advantage when it comes to operations. Smaller players must find a way to level the playing field, and mutualizing costs is one method. However, there is more than one way to share the post-trade burden robustly, and it doesn't have to be an "all or nothing" decision.

An uphill battle against flow monsters and category killers

In 2012, the 5 largest banks raked in $63 of every $100 in profits earned by the 15 largest banks, up 13% from 2006.[1] This is not surprising if you consider that over those six years, the five largest banks grew considerably larger than the rest, and for every additional $1 billion in assets, a bank's annual operating costs decreased by $1 million to $2 million.[2]



Source: Public data, annual reports

Figure 1- Corporate and Investment Banks - Margins and Revenue

These economies of scale can be traced to a change in Wall Street's cost structure, with fixed costs becoming increasingly material. Ongoing regulatory reforms have driven up fixed costs related to technology and operations across the industry; however, midsized banks, unlike their larger peers, do not have the luxury of apportioning these higher fixed costs over a very large number of trades. Economies of scale apply to midsized operations, and are increasingly squeezed now that the profitability of individual trades has decreased. As a result, midsized banks spend between $120 and $200 per trade on technology and operations, compared to about $50 per trade at larger banks. If midsized banks are to improve their profitability, they need to adjust their operating model and slash their trading costs at least 30% to 40%. Failure to do so may result in even more drastic business-model choices and force a move into niche, high-margin businesses.

Mutualizing costs to bridge the cost gap

Post-trade services have become increasingly commoditized, and now banks compete primarily on the cost of providing these services, not on their quality. Across post-trade functions such as reconciliations, trade processing, regulatory reporting, and collateral management, little differentiation can be obtained even by being the very best. However, there is a lot to lose by executing these functions poorly. Tried-and-true cost-efficiency levers such as process optimization, traditional outsourcing, and application simplification may be only part of the solution. As a result, Tier 1 banks have used their scale to build large, captive shared services centers to be more efficient, but midsize banks that lack in scale may need to go a step further.

One option for such midsize banks is to partner with an operator to develop a shared services program focused on a specific post-trade activity, with the bank designing the offering and the operator investing in developing infrastructure for shared services. The engagement would begin with traditional business process optimization (BPO). Subsequently, as other banks sign up, the engagement would turn into an industry-wide shared services setup. This is when the founding bank's costs would get mutualized, and it would also have the potential benefit of a new revenue stream, derived from each new bank participating in the service.

Another option entails a group of banks coming together to share the cost of operations using a common technology platform, by joining forces in a true shared services program run by a neutral non-bank partner. This reduces the average cost per trade in stable conditions but, more importantly, helps banks cope with the increased volatility in trading volumes. By linking the cost of services received to transaction volumes, there is an opportunity to convert at least part of the fixed costs to variable costs.

The tipping point: a comprehensive risk/benefit analysis

Despite widespread consensus about the benefits of sharing post-trade costs (with estimates ranging between $1 billion and $3 billion in annual sell-side savings[3]), there is still no operational post-trade processing utility in place. There are multiple reasons, including the inability to match the best operational metrics, the most streamlined process flows, and the most scalable technology platform to one service. Add to that differing views on the required level of cost reduction or whether a centralized service would create added operational risk that may counteract the potential cost savings in various functions, such as trade processing (40% to 50% benefit in cost per trade) or reconciliations (25% to 30% savings).

What are firms really measuring when they conduct a risk/benefit analysis? Many operations groups do not have a transparent view of their process metrics. For example, very few banks can pinpoint their trade processing costs on a per-trade basis, their combined spend on trade processing operations and technology, or their function-specific performance metrics. This is no surprise given the siloed nature of operations and the technology sprawl in back offices, but this in itself creates additional operational risk. A post-trade operator with the ability to provide on-demand dashboards covering performance, costs, and volumes by asset class and function would mitigate that risk. This should be considered to gain a complete picture of the risk/benefit analysis.

Starting the dialogue with carefully chosen functions

To move forward, three sets of industry conversations need to evolve.

First, the conversation about the scope of services to be shared. A bank could adopt shared services for all post-trade functions in a staged transition starting with non-differentiated, low-risk functions that gradually moves to higher-touch activities. However, given the enormous complexity of such a program, the prudent approach might be for banks to limit themselves to running just one or two post-trade functions such as reconciliations and collateral management in shared services mode.

Second, the conversation between banks and "operators." Currently, no post-trade utility offers a complete solution including technology platforms, process flows, and performance benchmarks. The most likely answer will come from a partnership among platform providers, operations experts, and the banks themselves.

Third, the conversation with regulators. With the OCC and the Federal Reserve issuing guidance aimed at stiffer vendor risk management, banks want to discuss the compliance and data security challenges expected in a shared services environment. This means that the conversation between banks and service providers must move to the next level of detail regarding client data and personnel processes to give all stakeholders the clarity they require.

Although the journey to true transformational change has many more hurdles to clear, the industry will continue to move forward. Skeptics need only look at similar situations unfolding in other functions, such as **KYC**[4] and client onboarding, where banks and operations experts have already cracked the code for groundbreaking industry-shared services. As in that space, COOs and regulators alike will continue to recognize and welcome the potential cost and oversight benefits that come from shared and standardized operations, elevating post-trade processing to an entirely new playing field.

1. *Wall Street Journal*, May 20, 2013
2. Federal Reserve Bank of New York, March 2014
3. Morgan Stanley, Oliver Wyman, "Wholesale & Investment Banking Outlook," 2014
4. http://www.kyc.com

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