Transformation in Securities Services

Strategies to remain competitive and ensure a viable future
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Global securities services providers hold trillions of dollars in assets under custody, and clear and settle trillions worth of transactions. In time, they have evolved to play a critical role in securities markets, making them ideal partners for clients that want to operate across global securities markets and in multiple asset classes. They have moved on from mere safekeeping of assets to providing value added services to market participants.

However, the global financial crisis has had an adverse impact on the functioning of these players. The financial crisis resulted in a wave of regulations, lower margins, rise in cost-income ratio, and increased demand for operational transparency. Investment banks, which posted strong revenues and earnings in the pre-crisis era, are facing regulatory pressure in business segments of equities and fixed income, currencies, and commodities (FICC). This pressure is affecting their Return on Equity and forcing them to look at new business models.

This paper examines the challenges facing securities services firms (clearing organizations and depositaries) and capital markets firms (asset managers, investment banks, and broker-dealers), and the strategies adopted by them to remain competitive and viable in the future.
2. Overview of the Securities Services Industry

While there is no standard definition of securities services, for the purpose of this paper, securities services refers to all services/operations in the post-trade arena, including:

- clearing and settlement of securities
- safe-keeping of assets
- securities lending
- prime services
- fund services

Firms providing securities services and processing functions within capital markets play a critical role for institutional/retail clients across multiple asset classes/geographies.

The securities services industry is a business of scale and firms primarily derive revenues from safe-keeping of assets, clearing and settlement of securities, securities lending and foreign exchange, and asset servicing. After much consolidation activity over the last decade, the industry is now concentrated in the hands of a very few players, such as Bank of New York Mellon, State Street, and Citi in the U.S. and BNP Paribas, HSBC, and Societe Generale in Europe. These players also have a strong foothold in the Asia-Pacific market.

Exhibit 1: Offerings of Securities Services Industry

While the securities services business has traditionally been a transactional business where size mattered and annuity type revenues from traditional revenue streams kept the engines oiled, the financial crisis has presented numerous challenges, forcing firms to change their business models. However, these challenges have also brought in a new array of opportunities to remain competitive in future.
3. Challenges

The securities services industry, which is already among the most concentrated segment in the financial services industry, is experiencing numerous stress points in the form of lower margins, higher cost income-ratio, and stringent regulations.

Prior to the financial crisis, securities services were enjoying the best period in their history. Strong performance of equity markets worldwide led to year-after-year growth for pension funds, asset management firms, and brokerage houses, which boosted profitability and revenues for securities services firms. However, the trend changed with the eruption of financial crisis, which wiped out trillions of dollars in stock market capitalization. Decline in the fortunes of investors as a result of the crisis negatively affected the performance of securities services firms, who handled their trades and serviced their accounts.

The securities services industry, which is already among the most concentrated segment in the financial services industry, is experiencing numerous stress points in the form of lower margins, higher cost income-ratio, and stringent regulations.

Exhibit 2: Challenges Facing the Securities Services Industry

<table>
<thead>
<tr>
<th>Forces of Disruption for Securities Services Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Decreasing Revenues and Fall in Margins</strong></td>
</tr>
<tr>
<td>• Margins declined from 43 basis points in 2008 to 30 basis points in 2012</td>
</tr>
<tr>
<td>• Decline in margins was driven by lower volumes in equity and fixed income, near-zero interest rates, drop in high margin securities lending activity, commoditization, and lower FX revenues</td>
</tr>
<tr>
<td><strong>Tough Regulatory Environment</strong></td>
</tr>
<tr>
<td>• Securities services are being significantly impacted by stringent regulations in terms of higher capital and reporting requirements</td>
</tr>
<tr>
<td>• Firms will need to make huge investment in technology to comply with new regulations</td>
</tr>
<tr>
<td><strong>Rising Cost-Income Ratio</strong></td>
</tr>
<tr>
<td>• CI ratio increased from 67% in 2008 to 76% in 2012</td>
</tr>
<tr>
<td>• Higher cost income ratio driven by lower top line growth, higher compliance costs, restructuring expenses, and law suit settlement costs</td>
</tr>
<tr>
<td><strong>Drop in Securities Lending Activity and Foreign Exchange Revenues</strong></td>
</tr>
<tr>
<td>• Securities lending revenues declined due to lower interest rates, and subdued mergers and acquisitions activity</td>
</tr>
<tr>
<td>• FX revenues declined due to increased price scrutiny, and lower volatility in the currency markets</td>
</tr>
<tr>
<td><strong>Higher Settlement Costs in Europe</strong></td>
</tr>
<tr>
<td>• Settlement and clearing costs are higher in Europe than in the U.S.</td>
</tr>
<tr>
<td>• Costs are higher due to lower volumes in European markets, multiple platforms, and ownership structure of the clearing and settlement entities (private ownership)</td>
</tr>
<tr>
<td><strong>Competition from Central Securities Depository</strong></td>
</tr>
<tr>
<td>• With T2S going live in 2015, there is likely to be intense competition between national central securities depositories and may lose some share of settlement revenues</td>
</tr>
<tr>
<td>• Hence, CSDs in order to make up for lost services may start offering custodian services</td>
</tr>
</tbody>
</table>

Source: Capgemini Analysis, 2014
3.1. Lower Margins

Assets under Custody (AuC) of top players (BNY Mellon, J.P.Morgan, State Street, Citi, and BNP Paribas) have increased since the crisis due to recovery in financial markets and new inflows. However, gross margins have witnessed a drop. Gross margins declined by 13 basis points to 30 basis points during the period 2008-2012, driven by lower revenues from high yielding security lending and foreign exchange (FX) business (see Exhibit 3). While security lending revenues were affected by lower interest rates and subdued mergers and acquisitions activity (reduced arbitrage opportunities), FX revenues were lower due to lower volatility in the currency markets, shrinking fees, and lower transaction volumes.

Margins were also affected by investors’ preference for safer asset classes and declines in the volume of equity trades due to uncertain market conditions. While equity markets strongly rallied starting 2010, the volume of equity trades globally declined from 11.5 billion in 2010 to 8.9 billion trades in 2012.1 Near zero interest rates also affected the net interest income margin of securities services players.

3.2. Rising Cost-Income Ratio

The aggregate cost-income ratio of the main competitors (BNY Mellon, State Street, BNP Paribas, Societe Generale, and Northern Trust) increased since the financial crisis, as top-line growth was affected by margin compression, uncertainty in the markets, and other macroeconomic factors. Cost-income ratio increased by 9 percentage points to 76% during the period 2008-2012 (see Exhibit 3). Restructuring costs related to transformation programs and higher litigation costs (lawsuits from asset managers and regulatory investigations over fees being charged) also negatively affected the cost-income ratio of the industry.

For example, State Street is being sued by California on the charge that its state pension funds have improperly charged for foreign exchange services. Also, in November 2012, to settle a lawsuit by the state of Florida over a claim of overcharging, BNY Mellon agreed to pay $28M.2 With a spate of regulations launched and more to be launched in the future, firms are also facing higher compliance costs in terms of additional reporting and investments in new technology platforms.

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1 World Federation of Exchanges

Transformation in Securities Services
3.3. Competition from Central Securities Depositories

Target2Securities (T2S), which aims to reduce the costs of cross-border settlement in the Euro area and is likely to go live effective 2015, will have a significant impact on the market participants involved in settlement and clearing process. National Central Securities Depositories (NCSDs) will lose some share of settlement revenues under T2S, and there is likely to be intense competition among NCSDs as the settlement will be done on the T2S platform. Sub-custodians will be the most affected as global custodians can directly connect to T2S. Sub-custodians are likely to face intense competition, as CSDs in search of alternate revenue streams will enter the traditional revenue-generating streams of sub-custodians.

The implementation of T2S also offers some benefits to securities services players. Global custodians which currently operate in fragmented EU markets through sub-custodians will benefit from the opportunity of rationalizing intermediaries by connecting directly to CSD. However, global custodians will need to make significant investments in technology in order to connect to a CSD.

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Exhibit 3: Margins and Cost-Income Ratio of Securities Services Industry

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>64.2</td>
<td>89.1</td>
<td>8%</td>
<td>76%</td>
</tr>
<tr>
<td>2009</td>
<td>62.9</td>
<td>81.1</td>
<td>8%</td>
<td>78%</td>
</tr>
<tr>
<td>2010</td>
<td>79.5</td>
<td>83.3</td>
<td>8%</td>
<td>72%</td>
</tr>
<tr>
<td>2011</td>
<td>81.1</td>
<td>83.3</td>
<td>8%</td>
<td>76%</td>
</tr>
<tr>
<td>2012</td>
<td>89.1</td>
<td>83.3</td>
<td>8%</td>
<td>76%</td>
</tr>
</tbody>
</table>

a. Gross margin has been calculated as total revenues from asset servicing business upon assets under custody for the top players of BNY Mellon, J.P. Morgan, State Street, Citibank, and BNP Paribas.
b. Cost-Income Ratio has been calculated as total costs upon total revenues for the top players of BNY Mellon, State Street, BNP Paribas, Societe Generale, and Northern Trust.

Note: Due to non-availability of data and industry being consolidated, gross margin and cost-income ratio shown in the charts above is being taken as proxy for the securities services industry.

Source: Capgemini Analysis, 2014; Annual Reports

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"T2S drives new breed of CSDs", The Trade, September 2013
3.4. Drop in Securities Lending Activity and Foreign Exchange Revenues

Revenues from securities lending activity has been on a decline post financial crisis of 2008 due to lower interest rates across the world (low interest rates make it difficult for lenders to earn a spread). The drop in revenues from securities lending activity can also be attributed to a temporary ban on short selling across major markets in times of stress and volatility. Fewer mergers and acquisitions in uncertain markets has resulted in loss of arbitrage opportunities.

Foreign exchange revenues declined primarily due to lower volatility (narrow spreads) in foreign exchange markets and increased scrutiny in pricing. Revenues have also been down due to lower volumes of transactions in currency markets and a pricing war among securities services players.

Source: ECB, ABBL

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Exhibit 4: Pre and Post T2S Clearing and Settlement Mechanism

<table>
<thead>
<tr>
<th>Pre T2S Clearing and Settlement Mechanism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Participants</td>
</tr>
<tr>
<td>CSD A</td>
</tr>
<tr>
<td>No integrated settlement process (domestic and cross-border)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Post T2S Clearing and Settlement Mechanism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Participants</td>
</tr>
<tr>
<td>CSD A</td>
</tr>
<tr>
<td>One integrated settlement process (domestic and cross-border)</td>
</tr>
</tbody>
</table>

Source: ECB, ABBL
3.5. Higher Clearing and Settlement Costs in Europe

Clearing and settlement costs are higher in Europe than in the U.S. due to:

- **Lower Volumes:** Clearing and settlement involves high fixed-costs. The cost per transaction will be lower only if the volumes are high. The U.S. market has significantly greater volumes than the majority of European markets and hence benefits from economies of scale.

- **Market Structure:** Differences in the ownership structure of settlement and clearing firms also play a major role in the cost differential across the Atlantic. Settlement and clearing services providers in Europe (e.g., Euroclear or Clearstream) are privately owned and operate on a for-profit basis, whereas Depository Trust & Clearing Corporation in the U.S. is user-owned and governed, and operate with an at-cost model.

- **Legal, Regulatory, and Technical Barriers:** Absence of a consolidated model for clearing and settlement is also resulting in cost discrepancies. European settlement and clearing systems are highly domestic-focused and fragmented (requiring multiple platforms and multiple parties), resulting in efficiency challenges. The U.S. market benefits from the consolidation of transaction flows through a single platform.

3.6. Tough Regulatory Environment

In the wake of the financial crisis, the securities services landscape has witnessed a spate of stringent regulations aimed at reducing systemic risk and enhancing consumer protection. These regulations are imposing a huge burden on firms in terms of additional capital, new reporting requirements, upgrading of existing technology systems, and development of new platforms. The regulations primarily affecting the securities service industry include:

- **Basel III:** Basel III, which is likely to become effective in 2015, increases capital requirements and requires custodian banks to hold enough liquid assets to get through a 30-day period of severe funding stress. Custodian banks will need to post higher margin when lending out their clients’ securities. Indemnifications issued to pensions funds and other market participants (who lend securities) will need to be reported on the balance sheet, making it subject to a capital charge.

- **Dodd-Frank and European Market Infrastructure Regulation:** The financial crisis exposed structural problems in over-the-counter derivatives market. The Dodd-Frank Act in the U.S. and European Market Infrastructure Regulation (EMIR) in Europe, in a bid to reduce systemic risk stemming from limited transparency and counterparty risk, propose the following:
  - All standardized contracts will be traded on exchanges/electronic platforms and also be cleared by a central clearing counterparty
  - OTC derivative contracts will be reported to trade repositories
  - Non-centrally cleared contracts will be subject to higher capital requirements

- **Target2Securities (T2S):** T2S, a European Central Bank initiative, is a Pan-European securities settlement platform that provides commoditized Delivery Versus Payment (DVP) settlements across all European securities markets. T2S is available for all CSDs that sign the T2S framework and aims at harmonizing settlement processes, including reduction of cross-border settlement costs. With the T2S initiative scheduled to go-live in 2015, market participants will have to make investments in systems in order to connect directly to the T2S platform.

- **Alternative Investment Fund Managers Directive (AIFMD) and Markets in Financial Instruments Directive (MiFID) II:** The AIFMD requires that each alternative fund manager maintain an independent single depositary for each fund and makes depositary liable for all losses to assets held with them and their sub-custodians. Under MiFID II, custody is likely to become a investment service. Firms providing this service need to ensure that the service is appropriate for clients and that clients understand the services being offered.
The securities services industry is currently beset by tough economic conditions, thin margins due to commoditized services, and higher costs. Also, it is a specialized business that requires regular investments to keep pace with changing regulations and sophisticated products coming to the market. While regulations present many challenges, they also offer opportunities. With fierce competition putting downward pressure on transaction and safekeeping fees, firms are implementing large scale transformation projects (revenue enhancement, cost optimization, and value-added offerings) to remain viable.

The same tough economic conditions and constantly changing regulatory environment is also leading broker-dealers, investments, and asset management firms to reconsider their operating models. Firms are looking at ways to make the best possible use of available capital. They are also placing renewed focus on front-end activities and are examining the handling of middle and back office functions themselves. Consequently, many broker dealers, investment banks, and asset management firms are considering outsourcing as an option. Some of the transformation initiatives being taken by the securities services industry are shown in the following exhibit.

Exhibit 5: Transformation in Securities Services

Source: Capgemini Analysis, 2014
4.1. Collateral Burden Owing to New Regulations is Leading to New Value-Added Offerings

Managing counterparty risk has emerged as one of the top challenges for buy-side firms after the global financial crisis. While the crisis resulted in increased scrutiny of the financial services industry in general, the over-the-counter derivatives market received the greatest focus. Hence, with an objective to reduce systemic risk and increase transparency, regulators in the U.S. and Europe introduced a number of regulatory initiatives governing OTC derivatives in the last couple of years. Under the new regulations, which are expected to be implemented in phases beginning in 2014, buy-side firms are likely to face increased initial margin requirements, forcing them to adopt collateral optimization and collateral transformation strategies. The key drivers for implementation of collateral optimization and transformation strategies are:

- Regulations have been proposed by the U.S. and European regulatory authorities to reduce systemic risk, improve transparency in the movement of collateral, and protect the funds of institutions and clients. For example, effective 2014, Dodd-Frank and European Market Infrastructure Regulation (EMIR) require that OTC derivatives be cleared by central clearing counterparties (CCPs) and this would require firms to post collateral.
- Large buy-side firms with operations across multiple geographies and asset classes need to deal with multiple CCPs, thus requiring them to put the collateral at their disposal to optimal use.
- CCPs require high quality collateral such as cash and government bonds, resulting in high costs.
- Firms are also adopting collateral optimization strategies to effectively deploy collateral across CCPs/clearing brokers and to better manage counterparty risk during the process.

Collateral Optimization and Transformation by Capital Markets Firms

Collateral management, which was once an ancillary function for capital markets firms, has entered the main stream after the global financial crisis and is currently being considered as a significant part of the regulatory compliance framework. This can be primarily attributed to regulations such as Dodd-Frank and European Market Infrastructure Regulation (EMIR), which require standardized OTC derivatives to be cleared by CCPs and non-centrally cleared derivative contracts be subject to higher initial margin requirements. Under the new clearing requirements, firms need to post high quality collateral to clearing agencies. This challenge could be further aggravated as the Basel III norms kick in.
According to various industry studies, collateral burden as a result of the Dodd-Frank and EMIR is likely to be between $500 billion and $6 trillion globally, making the sourcing of collateral a high priority issue for the industry. With high grade collateral availability getting scarce and costlier in the current market, capital markets firms are engaging in collateral optimisation and transformation strategies in order to make effective use of available collateral across the enterprise.

Impact

As a result of the financial crisis and collapse of some big firms, the OTC landscape is going to evolve significantly, including the emergence of central clearing counterparties.

Exhibit 6: Collateral Transformation Process

While the regulations of Dodd-Frank and EMIR have imposed collateral burden for capital markets firms, they have also created an opportunity for securities services firms to offer collateral transformation services. Collateral transformation involves the process of banks helping capital markets firms pledge their illiquid assets in exchange for acceptable liquid and high grade collateral. Securities services firms, in a bid to offset declining revenues and margins from traditional revenues streams of security lending, custodian services, and settlement and clearing, have started offering collateral transformation services to their clients. For example, BNY Mellon, Northern Trust, and J.P. Morgan have launched collateral transformation services, which offer to switch non-eligible types of collateral for higher-quality securities that can be used to back derivative trades.

Source: Capgemini Analysis, 2014; Wall Street’s latest idea, Financial Times, March 2013

As a result of the financial crisis and collapse of some big firms, the OTC landscape is going to evolve significantly, including the emergence of central clearing counterparties.
Historically, firms have been optimizing collateral manually using excel spreadsheets or outdated legacy systems. However, trading across multiple asset classes and geographies and dealing with multiple CCPs require an advanced solution. Hence, firms are implementing advanced collateral management systems that allow a firm-wide view of collateral balances. This helps in identifying excess collateral placed with brokers/clearing houses which could be pulled back appropriately. In addition, advanced collateral management systems also help in improving stress-testing capabilities, so firms can predict collateral requirements based on multiple scenarios. This enhances their risk management capabilities.

Though collateral management is primarily part of a cost center, its effective deployment can add to the bottom line, particularly for small and mid-sized firms. Firms with smaller OTC volumes can consolidate their transactions with a single clearing house (which has an excellent credit rating) and thereby more effectively manage credit risk. This will help in getting maximum netting benefits and decrease the effective cost of collateral. However, large firms, in order to strike a balance between netting benefits and counterparty risk diversification, need to work with multiple clearing houses.

From a technology perspective firms need to have collateral management systems that could be seamlessly integrated with other applications, including order management systems, trading systems, risk management systems and multiple data vendor feeds. Firms which rely on securities financing (repo and securities lending) for their trading, could replace multiple legacy collateral management systems with a single unified solution for the benefit of standardization. Firms also need to have collateral management systems that enable analytics, forecasting, inventory management, and stress testing on a real-time basis.

4.2. Strategic Alliances and Consolidation Activity

Strategic Alliances Among Post-Trade Infrastructure Providers to Address Global Collateral Crunch and Provide Global Collateral Solutions

Ever since the collapse of Lehman Brothers, there has been a significant emphasis on risk mitigation and greater transparency by post-trade infrastructure service providers. In the light of new regulatory requirements governing OTC derivatives markets, a large number of domestic and international financial institutions and their clients are reassessing the use of collateral to mitigate credit and settlement risk. Customers are increasingly requesting a complete range of enhanced collateral management offerings to match their needs. Clients want a collateral management infrastructure that is quick-to-market, cost-efficient, and regulations-compliant.

Capital market firms face the problem of not having the required systems to manage collateral on a real-time and cross-market basis. This problem is further aggravated as complex corporate architecture and international reach means that firms are unable to have a global view across all their positions and collateral pools. Even if some institutions have a single view, they lack the ability to move the right collateral to the right exposure at the right time.6

In the light of the above, financial market infrastructure providers (Central Securities Depositories) are partnering/collaborating with each other to launch liquidity alliances in order to ensure management of collateral. All the partners of the liquidity alliances will be using a common collateral management system which will enable common clients (of partners) to pool and mobilize their domestic and international central

6 “A sustainable solution to combat the global collateral challenge”, Australian Securities Exchange, June 2013
securities depositary assets on a single platform. These liquidity alliances follow an open-architecture approach and are open to new partners who are interested in joining/connecting to the common collateral solution. This increases the mutual benefits and opportunities open to all participating institutions and their clients.

For example, ASX (Australia), Cetip (Brazil), Clearstream (Frankfurt/Luxembourg), Iberclear (Spain) and Strate (South Africa) have launched a liquidity alliance under which, the partners will connect to the collateral management solution Liquidity Hub GO (offered by Clearstream). This will enable the clients of these CSDs to offer collateral in a particular country through assets held in other countries/currencies.

In a common collateral management solution, domestic collateral is retained in the partner CSD, thereby respecting the local financial market rules. International collateral is retained in the CSD providing the collateral management solution. One of the most significant advantages of the usage of a common collateral solution is that domestic collateral can be used to collateralize international exposures and international collateral can be used to collateralize domestic exposures.

Consolidation Activity in the Securities Services Industry
The securities services industry, which is already concentrated in the hands of a few players, is heading for further consolidation driven by stressed margins and higher cost-income ratio. Consolidation is primarily being driven by cash-rich bigger firms who have the capacity to make investments in updated technology and absorb financial pressures. Some banks, especially those in Europe, are also selling their securities services operations, in part to raise funds to meet the new capital standards under Basel III. Some of the recent deals in securities services include the purchase of ING's Central and Eastern Europe custodian operations by Citi and Standard Chartered’s acquisition of Absa Group’s custody and trustee business. Consolidation has also been driven by the strategic need to offer a wide range of offerings.

4.3. Transition to a Utility Model for Securities Processing
Investment banks and broker dealers are currently operating in a heavily competitive market. Shrinking equity and fixed-income volumes coupled with inflexible fixed costs have led to a rise in cost/income ratio, thereby significantly reducing the return on equity to single digits. This creates an urgent need for savings across the enterprise. This tough environment for institutions comes amidst stringent regulations being enacted by the financial regulatory authorities to reduce systemic risk and enhance consumer protection. At the same time, IT budgets are increasingly being strained by these new regulatory and reporting requirements. Investment banks and broker dealers that intend to remain competitive and viable in the new environment need to reduce operational costs and put their scarce available capital to efficient use.

7 “ING to sell custody services in 7 European countries to Citi”, Reuters, April 26, 2013
8 “Standard Chartered to buy Absa’s South African custody business”, Reuters, April, 18, 2013
This convergence of cost, regulatory, and technological burden has resulted in firms reassessing their securities processing activities. The diverse regulatory requirements and fragmented post-trade requirements across various geographies prevent investment banks from building a post-trade infrastructure that is scalable to support their needs. Also with some elements of the post-trade functions very much commoditized, firms can no longer claim competitive advantage.

In a bid to ride out the tough macro environment, reduce cost per trade, and slash fixed costs, firms are transitioning towards a utility model for their securities-processing operations. The utility model primarily involves the sharing of costs with other banks on joint platforms for various processes related to securities processing. The major benefits of a utility model for investment banks/broker-dealers include:

- Reduced post-trade processing costs such as the stubborn fixed costs of back office functions
- Reduced system and technology costs of complying with new regulations
- Greater visibility into costs associated with each part of the securities processing lifecycle
- Flexibility to select services firms for specific needs in addition to core functions of settlement processing
- Ability to quickly launch new products and enter new markets

For example, in July 2013, Accenture and Broadridge jointly launched Accenture post-trade processing, a solution to help banks in Europe and Asia-Pacific reduce post-trade processing costs. Societe Generale became the first client of this solution, and as part of the agreement, 50 employees from Societe Generale with post-trade skills will join Accenture.

While investment banks and broker-dealers reduce costs by outsourcing their securities processing operations, securities services can also take advantage of this transition. Revenue and margin-starved securities services firms can collaborate with other like-minded firms to combine their core competencies to offer post-trade processing solutions to investment banks/broker firms.

For example, in July 2013, Citi and UBS brought together their capabilities to create a post-trade processing solution named Post-Trade Plus aimed at offering non-core, middle-office clearing and settlement services to investment banks in Asia. This removes the need for post-trade infrastructure. Under the Post-Trade Plus service model, UBS will perform all the middle-office functions, and Citi will provide securities clearing, settlement and clearing services.

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9 “Accenture and Broadridge partner on post-trade processing tech”, Finextra, July 2013
10 “Citi, UBS create game-changing post-trade solution”, Asian Investor, July 2013
4.4. Increased Outsourcing of Middle and Back Office Functions by Asset Managers

Asset managers globally have been facing a tough operating environment in terms of generating returns, increased regulations, tarnished reputations, slowdown in revenues, and increased cost of operations. In the current environment, asset managers are facing headwinds to generate alpha and grow assets under management. With revenues coming under pressure, investment managers are proactively examining the non-investment aspects of their business and are outsourcing their middle and back office functions to shore up profitability. Some of the key trends that are driving asset managers to look at outsourcing include:

- **Intense Pressure on Fees:** Due to disappointing returns, there has been intense pressure from institutional investors to reduce the management fees charged by asset managers. This reached a tipping point with lower costs outweighing incremental performance. Investors currently prefer low-cost funds even if they slightly underperform higher-cost funds. Investors currently prefer low-cost funds even if they slightly underperform higher-cost funds. Considering the tough times ahead, hedge funds, which have historically operated under a 2/20 structure, are also facing pressure on fees. Currently, the average fee structure of a hedge fund is estimated at 1.6% for management fees and 18% of investment gains.

- **Diversified Portfolios (Multiple Geographies and Multiple Asset Classes):** With traditional revenue sources becoming strained, asset managers are diversifying their portfolios across alternative investments (real estate, hedge funds, private equity etc.) and exotic financial instruments to generate additional revenues. Additionally, asset managers have spread their portfolios globally.

- **Higher Operational Costs:** While investors are demanding lower fees, hedge funds and traditional asset management firms are also facing higher compliance costs due to increasing regulation. A raft of pending regulations including the AIFMD and Undertakings for Collective Investment in Transferable Securities (UCITS IV) are forcing asset managers to upgrade their IT platforms. The high cost of this investment is resulting in a series of cost reduction initiatives. For example, in March 2013, BlackRock announced its intention to lay off nearly 300 employees in order to create an agile organization. In a bid to reduce costs, asset managers are also outsourcing their middle office (post-trade compliance, risk management, client reporting, asset valuation) and back office functions (fund accounting, corporate actions, cash management and legal reporting).

**Impact**

With revenues coming under stress, asset managers are becoming increasingly focused on their core function of managing assets and generating returns for investors. The result is a heightened demand for outsourced solutions. This presents a significant opportunity for securities services firms to take over the non-investment tasks of asset managers. Securities services firms with the required scale and human capital are beginning to reposition themselves and building their expertise to move up the value chain and cater to the specific requirements of asset managers.

Increased allocation to alternative investments such as hedge funds and private equity also give rise to other revenue-generating opportunities for securities services firms. The Bernard Madoff scam in 2008 has driven investors and regulators to demand independent accounting and administration. With asset managers investing in global markets (multiple currencies) and in complex instruments (including credit default swaps and credit default obligations to generate returns), they will need to upgrade their technology systems. Securities services firms, in response to the above, are launching a single platform (that would enable asset managers to pick and choose the required services compatible to any asset class) and are moving up the value chain to offer valuation services for complex and illiquid asset classes.

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12 Nadia Damouni, “BlackRock to lay off nearly 300 employees”, Reuters, March 2013
5. Conclusion

While almost all segments of the financial services industry have been hit hard by the financial crisis, securities services firms have been affected less than investments banks and broker-dealers. For example, layoffs at securities services firms have been not been as deep as those at some of the broker-dealers and investment banks. However, with traditional income streams taking a beating in the last couple of years, transformation would help firms to supplement their income by offering innovative services to their clients and achieving operational efficiencies.

There are numerous opportunities for firms to increase the services that they provide to clients. Some of the services include collateral optimization and collateral transformation for capital markets firms. Securities services firms can also enhance their revenues by taking over the securities processing functions of broker-dealers/ investment banks and middle-office functions of investment managers. At the same time, by transferring non-core functions, broker-dealers/investment banks/ investment managers can keep their costs under control and focus on activities of strategic importance.

In addition to the above, securities services firms can also open new CoEs in low-cost locations to administer back-office and middle-office functions, thereby resulting in significant cost savings. Firms can also execute a technology transformation to reduce costs and stay agile in the market. Many securities services firms have grown inorganically in the recent past, resulting in multiple platforms across geographies and product lines. Firms can consolidate their operating platforms across the globe to reduce costs and increase speed-to-market. Firms can also move applications onto cloud platforms. That way, systems can be easily scaled up or down on demand and information is available on a real-time basis for clients. Firms can also engage in business process reengineering and manual process automation to reduce risk and increase efficiencies.

Finally, regulations surrounding OTC derivatives are likely to create a shortage of collateral and also make it expensive. Capital markets firms can implement robust and real-time collateral management systems that will enable them to track available collateral globally on a real-time basis. This will enable them to put the collateral available at their disposal to the best possible use as Basel III norms kick in.
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