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VIEWPOINT

THE SIX PILLARS OF POST-TRADE MUTUALIZATION

Financial institutions are increasingly turning to post-trade mutualization utilities to provide business enablement and risk mitigation benefits rather than just for their cost savings. The past success of these utilities has been variable given the way they were structured. So far, the debate has focused on why, where, and what should be mutualized. But for the how and when, organizations need to address six foundational pillars.

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The tipping point

The need to attack post-trade inefficiency has been building for years. The global financial industry spends more than $20 billion annually to process trades, according to a Bank of England report.[1] But this is done through a complex and unreliable web of outdated proprietary systems and overlapping processes. For instance, the processing of a single vanilla foreign exchange trade could require maintaining 20 different copies of the trade across 23 different services. Indeed, financial services could save about $4 billion annually if the industry standardized and mutualized — or shared – its post-trade activities.[2]

Until now, this inefficiency was seen as just a cost of doing business. But the financial industry is no longer as profitable as it once was. Low-to-near-zero interest rates have squeezed margins. Meanwhile, heightened regulatory scrutiny, and rising capital adequacy and regulatory costs have put pressure on the bottom line.

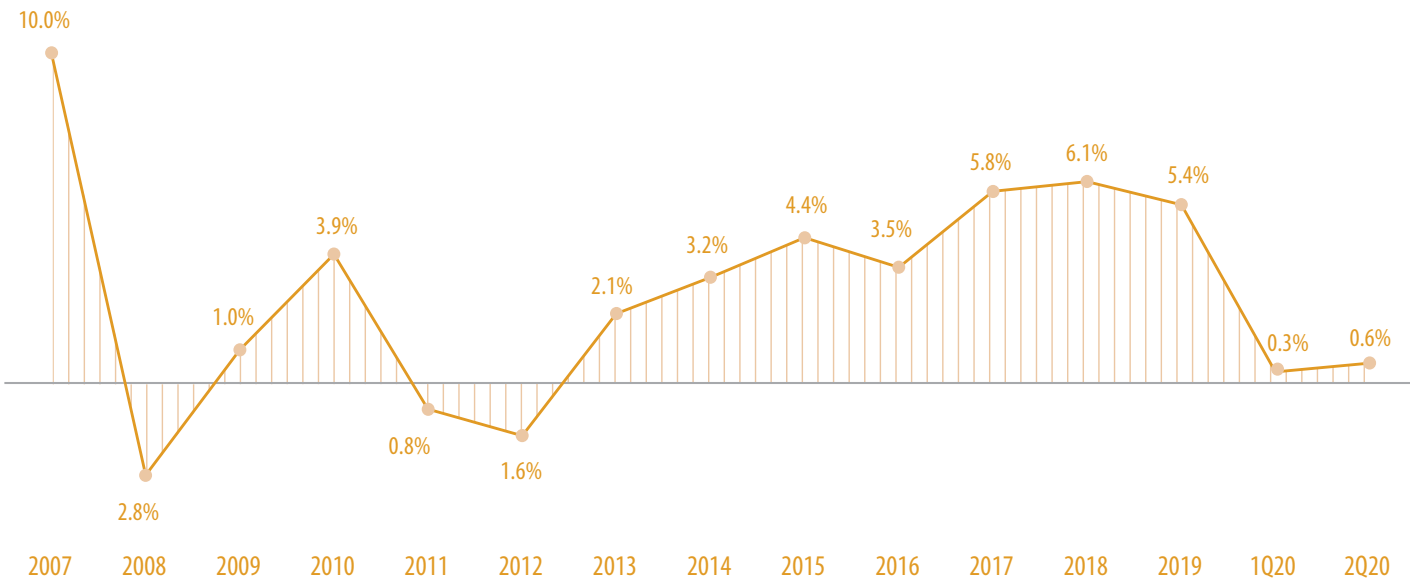
The European banking industry's return on equity (RoE) has averaged 3% over the past 10 years. And the pandemic has not helped (Figure 1). Indeed, McKinsey expects RoE for European banks to head into negative territory in 2021 and, at best, may return to around 5% to 6% by 2025.[3]

Although cost is the most obvious concern, it's not the only downside — or even the largest. Inefficient post-trade activities add significant risk to the financial system. An estimated 4% of trades fail when, for one reason or another (often a technical issue or miscommunication), collateral is not posted immediately to settle a trade. The complexity of different systems means that it typically takes two days to resolve these issues. In 2016, this delay accounted for an estimated $27 billion of ongoing exposure for sell-side firms.

There is also increasing recognition that inefficient, rigid back-office processes hinder companies' ability to develop more innovative or responsive products on the front end. New analytics capabilities, artificial intelligence tools, and automation techniques can do only so much if they are built on foundations that are inherently inefficient and unreliable.

It's no surprise, then, that there has been a resurgence of interest in rethinking post-trade processes. Organizations understand that if they can standardize and mutualize, they will be able to reduce costs and risks while enabling more innovation and competition. In June 2020, the Bank of England announced a working group of industry leaders to explore post-trade reform and standardization. Then, two separate platforms were launched in January 2021. One is a post-trade joint venture between CME Group and IHS Markit. The other is a data-first market operations utility called HUB, launched by PIMCO, Man Group, IHS Markit, State Street, Microsoft, and McKinsey.[4,5]

Figure 1. The pandemic has wiped out RoE gains of the past decade



Source: European Banking Federation, Infosys

Making mutualization work

Shared service utilities can come in many forms: joint ventures, outsourced entities, or, more commonly in finance, a mutualized service. But the success rate of these has been variable. The key to getting it right is understanding the dynamics that make a mutualized system effective for all parties.

One good example is the Depository Trust and Clearing Corporation (DTCC) in the U.S. Dating back to the 1970s, the DTCC is now the central depository for the U.S. market, processing securities worth more than $2.2 quadrillion.[6] Its success is based on providing a standardized service that is highly regulated. Notably, it's a service that is not seen as differentiating for each member bank, and therefore there is a straightforward cost-saving business case for and low barriers to moving to standard processes. In short, everyone has to do it by law, it's easy to migrate your process, and it doesn't make any sense to do it differently.

Compare this with a newer mutualized platform, Clarient. Set up by DTCC and six banks in 2014, Clarient's platform provides common know-your-customer and Foreign Account Tax Compliance Act services. Yet the service struggled as a mutualized platform and ultimately was sold to become a private service provider owned by Refinitiv, formerly part of Thomson Reuters. Success here was stymied by regulations that still left the liability with each member bank rather than with Clarient itself. This meant that each member effectively still had to take responsibility for the outcome, leading to many questioning the value of outsourcing this process when decisions still had to be double-checked.[7]

In addition to regulations and levels of standardization, poor expertise, governance, or commercial models all can foil the best-laid plans for outsourcing processes to a shared service. In the past, failed efforts have either been too focused on the technical elements without in-depth business understanding or vice versa. Ownership structures that are imbalanced or that do not provide enough incentive to the service provider or members can also kill a shared platform in the long run.

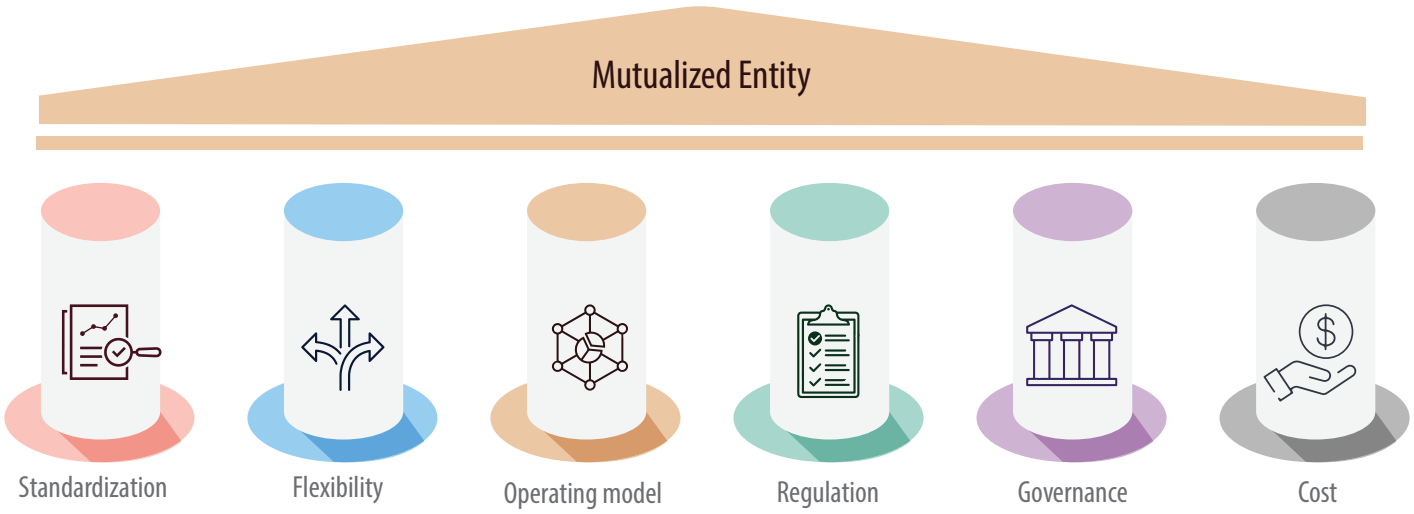
Overconcentration of processing on a single platform should also be avoided. Ideally, the market would consist of a range of post-trade utilities, each focusing on different regions, asset classes, or regulatory frameworks — and competing with each other. In this way, systemic risk can be avoided and innovation can be encouraged.

The six pillars of mutualization success

To achieve effective long-term commitment from its members, we believe mutualized services need to delicately balance the following six elements. Each will help make post-trade mutualization a success.

1. **Standardization —** All parties must agree on similar process steps.
2. **Flexibility —** Members must be able to customize and innovate on the platform.
3. **Operating model —** Members must review and reengineer processes.
4. **Regulation —** Members must be within the same regulatory framework, and liabilities must be clearly defined.
5. **Governance —** The ownership structure must support neutral service provisions and growth.
6. **Cost —** The speed and size of return on investment (ROI) must be a significant incentive.

Figure 2. The six pillars of an effective mutualized entity



Source: Infosys

1. Standardization

This is the bedrock of a successful shared service. The development of standards (ISDA CDM, LEI, ISO 20022), the need to comply with regulations, demands for better-quality data, and the use of common products and applications are becoming business enablers. Banks are starting to talk the same language. These act as a ready foundation when thinking of a mutualized construct.

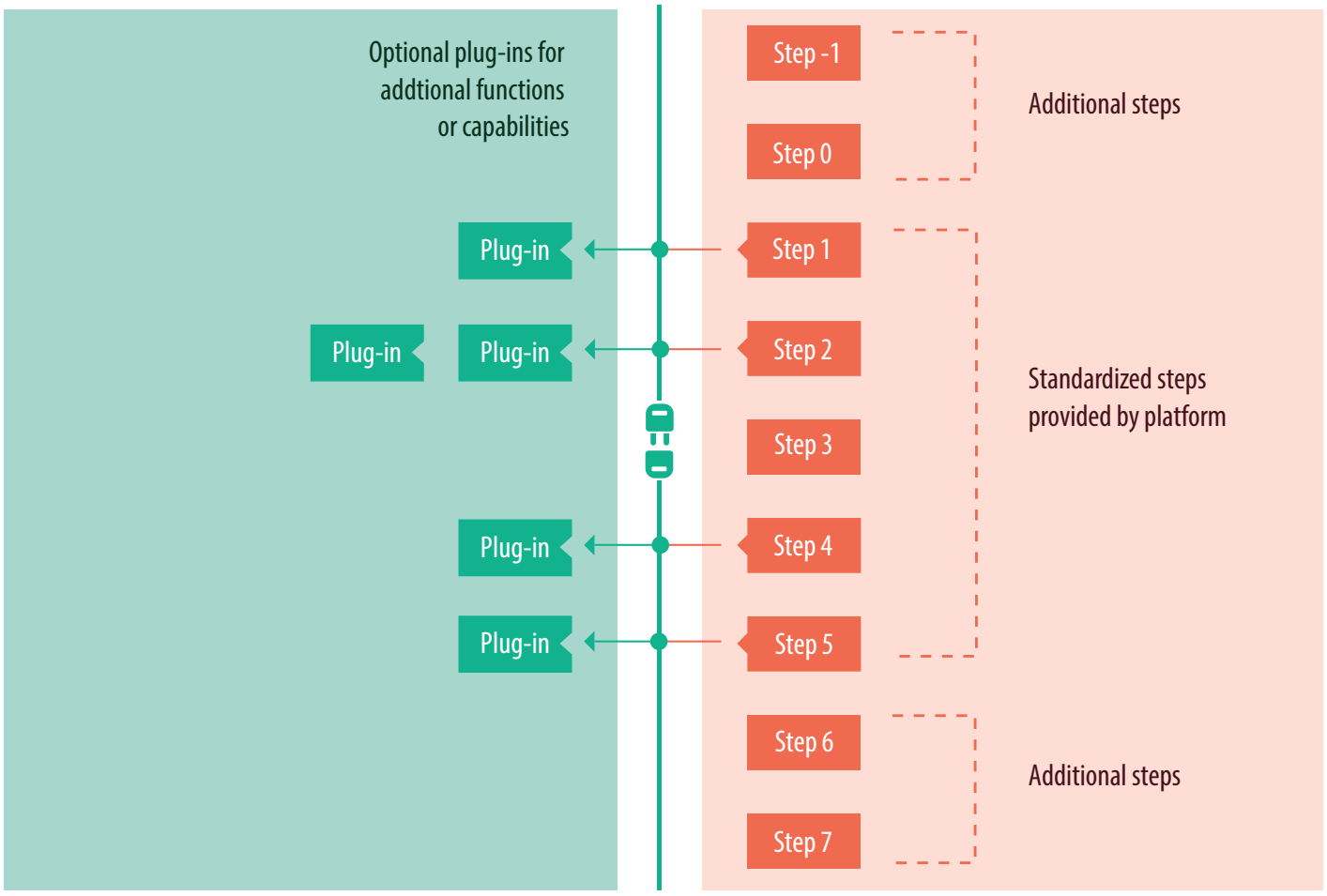
There is still a long way to go here, as most banks interpret regulations and standards differently. Also, their internal processes may be quite different from each other. Yet it is possible to agree on a set of process steps that all can share; this can be the starting point of a mutualized platform. However, there also needs to be the ability to customize and add on capabilities to suit each member bank (see Flexibility below).

2. Flexibility

A successful mutualization model requires the platform to be flexible across two frontiers. The first is the technical flexibility enabled by the use of application programming interface (API)-based cloud. This is perhaps the biggest difference between a shared service built today and one from five or 10 years ago. API-ification allows quicker and easier integration when transforming, thus delivering an earlier ROI. It also equips the mutualized platform to evolve more easily and to provide bespoke elements or plug-ins in a more seamless way. With APIs, institutions can flexibly connect or disconnect any process on top of the core process steps within a mutualized platform. They can also access new capabilities or service plug-ins provided by third parties (Figure 3). Crucially, this enables a modern mutualized platform to provide innovation and customization on top of a core processing capability in a way that still encourages sharing and cost-effectiveness. No longer would a member have to build its own customizations in-house when it could buy or build them on the platform and share the benefits with others.

> API-ification enables faster and easier integration, thereby delivering an earlier ROI

Figure 3. Mutualization allows flexibility without diluting standardization



Source: Infosys

Second, a mutualized utility should act as a business enabler and support its customers' growth and expansion. Customers should be able to build and grow their businesses by entering new markets and activating trades across regions and asset classes without having to invest time, money, and effort in an underlying system. For example, building and implementing a new platform such as a post-trade system is time-consuming and expensive. But a utility's API-based platform can enable this — either through the creation of add-ons or by allowing the processes' steps to be modified by each customer. Using the utility's reliable, tested system for an activity reduces the customer's time and cost to market.

3. Operating model

Mutualizing processes for banks isn't as easy as a lift and shift of processes. Banks have thus far been vertically integrated entities. They own the platforms, people, and processes of conducting their business. As a result, it isn't as easy to break out their processes or application or to exchange data externally.

Before joining or creating a mutualized venture, banks need a strategic review of their existing processes, including a fundamental rethinking of their operating model. To mutualize, banks would need to review, reorganize and, if required, restructure their processes, applications, and data. These involve a lot of preparatory work in the middle and back offices.

A complete process and application review is needed to help banks understand what is possible. That would cover processes that can be held within the bank, exception management, what parts of the process companies can buy from the mutualized entity, and integration of processes from the utility back into the systems for reporting. A readiness to reorganize would require an organization to lay out its processes clearly and to decide where the process must stop, move to the utility, and then come back into the bank. Extensive planning and reengineering of the operating model would help intertwine a bank's internal web of applications and processes with the external utility.

Yet this is not enough. A change in culture and mindset is required to be organizationally flexible and to overhaul the operating model. While APIs do the job on the outside, the evaluation of the end-to-end processes is required from within. A well-managed operating model enables easy, two-way flow of data and better digests add-ons.

4. Regulation

A harmonized and standardized regulatory environment is a key piece of the success of a mutualized financial services ecosystem. While we are still far away from this goal, attempts have been made recently in the form of the Volcker Rule and the Dodd-Frank Act. But in the near future, regulatory complexity means that most mutualized services will likely be limited to use within a country or a region that has a shared regulatory framework. This in itself is not too much of an issue; much efficiency can still be gained by mutualizing processes within each market. And it is preferable that there are multiple competing, overlapping platforms rather than concentrating risk on one platform. However, regulators do need to engage in the mutualization process, modifying their rules to best support the correct locus of liability in order for utilities to successfully function.

Regulators will likely place most of the liability on banks. However, the utility needs to minimize the bank's risk and keep itself well managed from a regulatory viewpoint. Clarity of who will bear or share the liability — the utility or the participants or both — must be clearly laid out. Risk management must also be transparent on how such risks will be managed. This requires a framework with clearly defined procedures.

5. Governance

Governance model: The objectives of the promoters and participants in a shared service must be aligned. The governance model should balance benefits (commercial), provide continued services (stability), and grow the scope of services (innovation). This ensures transparency and equality of participants, keeps them engaged, and ensures a clear channel of communication and escalation.

Commercial model: There are different commercial constructs (fixed fee, volume-based, outcome-based, fixed plus variable) that suit different utilities, depending on their customers. This would allow customers to be onboarded easily and to foster innovation as the utility attempts to meet the demands of multiple organizations. But again, a more modern API-based platform can also benefit from becoming a flexible marketplace of services — one that supports an ecosystem of capabilities and technologies available to its participants. This should help balance value generation across a wider group, using a marketplace business model in place of a typical utility or joint venture model.

Ownership model: Ideally, the promoters of a service would combine technical expertise as well as deep banking and regulatory knowledge. They cannot be mutually exclusive. Therefore, an ownership structure where multiple linchpin banks come together to validate a platform, created jointly with an independent third party, provides the right balance among benefits, continued services, and innovation. DTCC is a good example: Banks are the keystone clients and also their shareholders that help in governance. Yet the utility itself has the independence to act commercially. The structure must govern neutral and fair treatment of each member to ensure that none will be advantaged or disadvantaged by the utility's capabilities. The platform itself should be designed to attract a range of smaller banks to keep it competitive.

6. Cost

A combination of cloud computing, API integration, and software licensing models creates a quicker ROI for mutualized platforms. But a few requirements are needed for the cost model to work. Cloud computing and APIs help build cost-effective platforms and significantly lower the burden of migration from legacy systems to a new shared platform. For software licenses, Murex and Broadridge can lower costs for midmarket customers through multitenant licenses, which are expensive to buy outright. Bankdata offers this service in Denmark — through a Murex multitenant license — and has reduced the total cost of ownership and burden of maintaining an information technology infrastructure for its customers.[8]

These sorts of licensing models can complement savings made by cloud and API-ification.

> Cloud computing, API integration, and software licensing models together create a quicker ROI for mutualized platforms

Financial institutions can gain far more than just economies of scale by utilizing the services of a mutualized platform. An entity built on these six pillars will help better manage the risks posed by inefficient post-trade activities. While standardization of processes and automation results in lower operational risk, a clear delineation of processes between the bank and the utility helps make it transparent about where the ownership and risks lie.

Baby steps to a big bang

Mutualization is more than a cost-reduction strategy. It will create more competitive markets where many smaller businesses can participate. And all can begin investing in new asset classes after outsourcing to a single cost-effective back-office platform. This, in turn, will create much more economical and innovative financial products for all. Mutualization is, in truth, a necessary evolution for the world's financial markets to modernize their decades-old infrastructure and processes.

This change, however, won't happen overnight. The first platforms that emerge will need to focus on niche regions, market segments, or process areas in order to ensure success. There are clearly many opportunities to attract midmarket institutions to shared utilities, if only because they struggle to compete with larger companies and to afford their own back-office processes. But over time, mutualized platforms will prove that their use of cloud and API technology creates a thriving marketplace for innovation and value generation. When that tipping point arrives, this market will suddenly move from baby steps to a big bang.

> Mutualization is an unavoidable adaptation to today's financial markets to modernize infrastructure and processes

Larger institutions may not feel the pinch yet. But soon they will have to decide whether they want to compete with, join on, or build their own platforms for others to use. There is no simple answer, but now is the time to make the decision.

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