



Outsourcing – Competing in A Changing Environment

Challenging market headwinds and rising costs are prompting more banks and brokers to outsource operations.

Despite inflation slowly trending downwards, markets remain volatile as geopolitical tensions and recessionary risk continue to grow, which – in turn – is making it harder for firms to generate revenues.

Compounding matters further is that many institutions have seen their margins progressively shrink due to the costs of dealing with shorter settlement cycles, regulatory changes, poor capital optimization, rapid digitalization, falling commissions, and soaring transaction volumes. Amid these difficult market conditions, financial institutions are constantly looking for ways to manage their spiralling costs.

Market changes put pressure on the industry

The transition to a T+1 settlement cycle in the US, Canada and Mexico will have major consequences across the trade lifecycle and is expected to kickstart a domino effect. Other markets (e.g., the UK, Europe and parts of Latin America) are expected to follow suit – while India – which completed its phased-in rollout of T+1 in January 2023 – is already talking about the possibility of introducing a voluntary T+0 settlement cycle later this year. Meanwhile, Sri Lanka's main stock exchange – Colombo Stock Exchange – recently announced that it too would shorten its settlement cycle for equities from T+3 to T+2 in May 2024, subject to regulatory approvals.

With less time to carry out post-trade processing, the number of trade fails is expected to rise in the short-term, potentially resulting in financial firms facing higher operating costs and overdraft charges.

To prepare for T+1, some organizations are looking to invest into new technology and automation. Firms based in Asia and Europe may also need to consider deploying post-trade processing teams to North America or introduce night shifts, further adding to their fixed cost base.

Beyond T+1, worsening geopolitical tensions (i.e. China and the US, Russia and Ukraine, Middle East, etc) are also taking their toll, especially for organizations with footprints in affected markets. In some instances, firms have had to execute their

business continuity plans and relocate operations to third countries, creating additional overheads.

Updates to post-financial crisis regulations are also causing problems for financial institutions. For instance, EU regulators are debating whether to introduce mandatory buy-ins for trade settlement fails as part of the Central Securities Depositories Regulation (CSDR) Refit, especially if they conclude that cash penalties are not resulting in better settlement discipline. Elsewhere, the latest revisions to the European Market Infrastructure Regulation (EMIR) – otherwise known as EMIR 3.0 – will likely force financial institutions trading certain Euro (and Polish Zloty) denominated OTC derivatives to have an active account with an EU authorised central counterparty clearing house (CCP).

As investors increasingly demand access to more markets, banks and brokers' regulatory workloads will only intensify. Although regions such as the EU have largely homogenous regulatory frameworks, the exact opposite is true in places like Asia, where markets are highly fragmented. Ensuring compliance with these different – and occasionally arbitraging – regulatory regimes can be a resource-intensive process.

As more markets adopt T+1, the geopolitical situation deteriorates, and regulations are revisited (i.e., CSDR Refit, EMIR 3.0), margins will continue to fall as technology and maintenance spending rises. As a result, a number of firms are looking to transition to a variable cost structure, a move that can be facilitated through outsourcing.

By externalizing certain functions, financial institutions can better scale their businesses and streamline operations, as they will no longer need to invest into the technology and infrastructure themselves. It will also enable firms to redeploy headcount away from non-revenue generating areas (i.e., post-trade processing, regulatory compliance, etc.) to front office activities (i.e. client relationship management, the provision of trading ideas to customers, etc.), which can help clients obtain alpha.

Lifting out certain operational processes also means that when firms access new markets, they can begin trading more quickly.

In the case of T+1, some custodians are able to offer a “follow-the-sun” operating model, which will help financial institutions in different time-zones to North America manage the impact of shorter settlements. Many custodians also provide clients with true Straight-through-Processing (STP), meaning banks and brokers should be able to fully automate their operations ahead of the T+1 go live date, but at a fraction of the cost of building the technology themselves.

And finally, many custodians offer their clients direct access to local subject matter experts, who can support them with their T+1 and regulatory compliance requirements across multiple markets.

The cost of capital keeps going up

The cost of capital for financial institutions is rising sharply, and this is having an adverse impact on their operations. There are several reasons why this is happening.

Notwithstanding the post-COVID spike in inflation and interest rates, accessing liquidity across global markets can be cost-prohibitive for some institutions, as it requires them to connect to and maintain linkages with multiple trading venues, often at vast expense.

Balance sheets have also been squeezed by post-financial crisis regulations (i.e., Basel III risk weighted capital requirements, margining requirements for centralized clearing, etc.) and provisions in a number of markets stipulating that brokers must deposit additional capital into so-called guarantee funds, an investor protection mechanism designed to safeguard customers from broker defaults and/or failures.

In this capital constrained environment, institutions are looking for ways to deploy their cash more efficiently, which has led to a renewed interest in outsourcing and service provider consolidation. In addition to externalizing back-office functions, some banks and brokers are entrusting custodians with a number of middle and front office responsibilities too, such as collateral management and risk reporting. Custodians can also help banks and brokers move away from the traditional self-clearing model. By delegating some of their centralized clearing responsibilities to custodians, firms can unlock trapped capital, as it allows for collateral to be released, reduces the costs of direct CCP membership, and frees up internal resources.

Again, this helps reduce the cost of capital for banks and brokers at a time when balance sheets are under significant pressure.

Digitalization does not come for free

As firms look to future proof their operations, they are launching new products and features. Some banks and brokers are looking to capitalise on the growth of digital assets by developing digital asset solutions, including custody, trade execution, margin financing and securities lending. Others are refining their data strategies or even exploring ways to leverage artificial intelligence (AI) so as to improve client experiences and obtain operational efficiencies. Additionally, many financial market infrastructures (FMIs) are re-platforming their entire operations for the exact same reasons.

However, digital initiatives of this sort often require significant monetary and headcount investments and may drain bandwidth when internal resources are already being badly stretched.

Re-platforming, for example, is costly for the FMIs, but it also requires institutions to spend sizeable sums on maintaining connectivity with those FMIs as the changes are rolled out.

At the same time, if a bank or broker needs to engage with a fintech on a digital change project, it will typically require them to conduct thorough due diligence on that provider first, creating additional operational (and possibly compliance) challenges.

Upgrading technology infrastructure to unlock the potential of data from pre-trade right through to post-trade is not an easy undertaking either, and typically needs buy-in and engagement from the entire organization. This consumes a large amount of resources and requires substantial infrastructure adaptations, which for many businesses is unsustainable to perform in-house.

In some cases, financial firms spend too much time and effort developing new technologies at the expense of their traditional technology stacks, resulting in problems going unnoticed at the latter. There is also no guarantee that investments into digital transformation projects will yield positive results, with Blockchain being a good example here.

While there have been high profile Blockchain success stories such as Hong Kong Exchanges and Clearing LTD's (HKEX) Synapse solution, a tool that uses Digital Asset's DAML smart contracts to support northbound trading between Hong Kong and China on Stock Connect, other schemes have fared less well.

Partnering with one's custodian can help shield firms from these research and development (R&D) costs, as the larger organization may already have deep rooted relationships with fintechs, who they routinely collaborate with when developing innovative or new technology solutions. For this reason, many banks and brokers are now leaning on external partnerships for support when executing their digital strategies rather than doing it all themselves.

Instead of being overwhelmed by R&D and digital change programmes, this setup lets banks and brokers focus on their core competences.

Facilitating resilience during market turbulence

Sparked by a succession of black swan events (i.e. COVID, an escalation in geopolitical tensions, regional banking crisis in North America etc.), transaction volumes have surged lately, putting enormous strain on banks and brokers' technology infrastructure and systems.

In response, many financial institutions are having to ramp up their spending to ensure that their front, middle and back-office systems are adequately equipped to withstand these sporadic spikes in trading volumes.

Custodians can insulate banks and brokers' systems from gyrating market conditions, as they already handle large trading volumes on behalf of numerous clients.

This model gives banks and brokers greater flexibility, as they do not need to hire additional headcount or scale up their infrastructure when volumes peak. It also means they are not saddled with large, fixed costs if trading volumes subsequently decline.

An outsourced model as an enabler

Costs are only moving in one direction...and that is up!

Simultaneously, margins are coming down at a time when banks and brokers are looking for new income streams to counteract the revenue contraction caused by the shift from active to passive, and the growing adoption of robo-advisory solutions.

In order to obtain synergies and strengthen their operations, firms need to re-think their existing business models.

Outsourcing is one of the options available to them.

Increasingly, more banks and brokers are consolidating their outsourced relationships and working with fewer – albeit larger providers, who can offer them a wider range of services. Not only can this approach reduce costs, but it will help financial firms comply with various market changes, free up immobilized cash, support their efforts to digitalize, and improve resilience when markets are becoming increasingly unpredictable.

This allows new entrants to be closer to the market and existing firms to continue to stay close to the market without the need for heavy investment into infrastructure and technology.

To find out more about how we can help you navigate this upcoming move to T+1 , or with reviewing your operating model, contact your Citi Representative or email SecuritiesServices@citi.com.

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