ASCENDANT STRATEGY

Outlook 2020

Unlock the future of post trade – time for real transformation in capital markets

December 2019

Strategic. Evolutionary. Practical.

Executive Summary

Many banks are facing the horror of 'double jaws' – decreasing revenue and increasing costs – taking some to a cost/income ratio of greater than 100%. With restructuring and rationalisation of business models, front office cost has been removed but the post-trade world stubbornly resists proportional reductions. To survive, CXOs must rethink how to transform this cost base – it's not going to happen by incremental 'skimming' cost cuts.

To succeed with a transformation that yields 40% total cost of ownership (TCO) reduction, we believe that the basics – a clear Strategy and Vision – need to be defined and communicated clearly to the broader organisation, alongside metrics that establish the starting point and demonstrate progress. But to shape the programme itself, there are three key aspects to get right:

Re-think your operating model, to support the business of today and tomorrow not yesterday. Though your business model has evolved, your operating model has not and this is at the core of cost challenge.

Align technology to the operating model, not let it define it. IT must enable the transformation, it is not the transformation itself.

Leverage external services – mutualisation is key. People, applications, infrastructure.

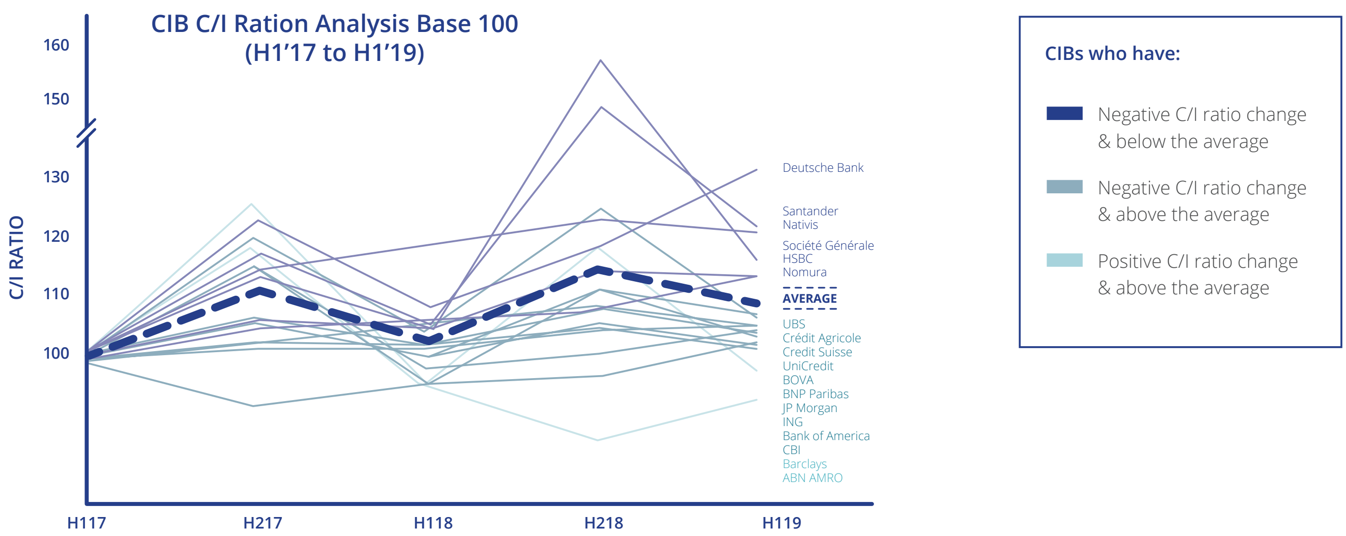
Time for real post trade transformation within capital markets

The last decade has taken most banks on a cost journey, from post-2008 survival – think 'regroup', through to 'restructure' and then ultimately 'rationalisation' – of business models. Most organisations will recognise this journey and some of the characteristics associated with it. And whilst most organisations can highlight certain success factors around progress, the reality for many is that failure to successfully transform their operating models is contributing to lack of sustained business profitability.

Why do we think this?

Failure to deliver a sustainable cost base has ultimately created an environment of unprofitability for all but the global, universal players whose business can deliver revenue at scale. Delivering sustainable revenues across the capital markets spectrum has been challenging for much of the industry, with the changing regulatory dynamic over the last decade adding significant cost to business models – both ongoing cost of compliance and also increased capital utilisation. As the industry has restructured, the reality of revenue never returning to save profitability sank in – with many organisations finally accepting the rebased revenue environment in which they now must operate. But this rebasing of the revenue environment has not been mirrored in the cost base.

Research below from Eurogroup Consulting highlights the reality in which much of the industry now operates, where sustained revenue reduction has not been offset by a right sizing of the cost base – creating a bleak cost/income (C/I) picture for much of the CIB (corporate and investment banking) industry.



Source: Eurogroup Consulting – EUROPEAN CORPORATE AND INVESTMENT BANKING OUTLOOK 2019

What this graphic shows in real terms is that despite extensive cost reduction and business restructuring efforts from earlier in the decade, the stark reality is that of an unsustainable trend. And the economic reality of this inefficiency has become clear through some of the public actions taken by some in response – and whose struggles to control this metric can be clearly seen on the graph.

As the capital markets landscape has restructured, cost focus has been led by obvious levers – front office exits, business shutdown, capital release – which has generated relatively quick impacts to the cost base. What remains however is increasingly sticky and complex to unwind, with the post trade environment accounting for an increasing proportion of this number. Estimates vary by firm, but in some instances almost 25% of revenues of CIB's are spent on post trade cost across process and technology[1]. And while the industry may have adjusted to the new economic reality of lower revenues against a higher cost base of operating (regulatory and capital cost), this adjustment has not been reflected through the post-trade environment. Given its increasing contribution to the overall cost base, failure to act will ultimately force boards to follow the examples of Deutsche Bank and others in taking drastic action.

Status quo will not make cost sustainable

Many organisations are grappling with post trade infrastructure and process that has been built up over time – and the unique complexity associated with their business. And for good reason, this complexity is tough to unravel and it isn't a quick task. Bringing in off the shelf solutions is hard – customisation of a vendor product is expensive as the functionality cannot be resold to others (due to its personalisation) and the level of in-house standardisation required to fit an off the shelf solution bank-wide is significant. Most C-suites have experience of this, and it can create significant risk aversion to change.

Unfortunately, this creates a 'rock and hard place mentality' – lack of change appetite due to risk and cost maintains the status quo, but the status quo is increasingly unable to deliver the material transformation required to create a position of cost sustainability. The reality of this environment is that organisations revert to *'skimming'* – *'What can we take out of next year's change budget?'*, *'Can we freeze new hires for a few months?'* – all of which reduces short term cost but does not create long term reduction in run rate.

But in addition to the challenge of legacy infrastructure is the set of legacy behaviours that persist alongside it. By continuing to look back, banks are hoping that traditional approaches to cost management will deliver sustainable business models of tomorrow. And failure to change these behaviours will ultimately see them following the recent examples of others where lack of profitability has driven business exit.

Our perspective – CXO's need to think differently about the challenge

Material change in the post trade cost environment requires a material change in thinking – but material does not have to mean destructive. The fundamental objective is for organisations to embrace the next decade as an opportunity for transformation leading to economic sustainability. Make cost and efficiency agendas career opportunities for talent to grow internally into the 2020's, rather than a competition to be last out of the door. The fear factor created by legacy change still creates inertia for many organisations we engage with, where the C-suite is frustrated by the status quo but lack insights or expertise to challenge this. This inertia will ultimately be fateful for many, who require in reality 30-40% reductions in total cost of post trade operations to survive in the new world.

Organisations must think differently about the problem to deliver success and leave legacy behaviours behind with their legacy architecture. Traditional approaches of top down budgeting (*'What can we skim?'*), point solutions for technology (*'Lets replace system a with system b'*) and basic ROI thresholds (*'This project must deliver positive ROI within 18 months'*) will not deliver a transformative outcome. Moreover, they will stymie efforts quickly and quash innovation before it starts. But if the challenge is addressed in the right way, there is opportunity for organisations to deliver major impacts to their bottom-line cost – and we believe 30-40% reductions in post trade cost are achievable if approached in the right way.

[1] 'Five themes for transforming wholesale banking operations and technology' by Mckinsey 2019

So how should C-level executives consider the challenge and think differently about the problem?

1. **The vision must be visible.** This has to be led and owned top down by the CEO/COO within the organisation who has control of the means of production. And this point is increasingly critical where shared ownership of a cost base – think different regions or entities sharing infrastructure – creates a complex web of stakeholders who lack individual accountability for the problem. Leaving this to functional process owners as an objective typically fails, as they lack budget and influence over other stakeholders that will make the vision a reality. The economic criticality of the objective requires this senior level of focus and can't be delegated to others – and though complexity of the problem shouldn't be underestimated, complexity itself shouldn't be an excuse for doing nothing. The vision should be articulating the challenge at hand, the value of the transformation and the future that success ensures. And sponsorship of this vision should be real and personal – not just a footnote at a quarterly townhall – to drive success.

   And while many organisations believe they do this, the reality is these types of transformation programmes often flounder because they lack real connectivity with a business objective. The vision must be forward looking and link tangible performance to clear business outcomes – so as an example, making the connectivity between sustainable cost optimisation and financial KPI's such as the C/I ratio. Creating this linkage enables the focus on cost to be tied to future proofing the business model, making the discussion forward looking (and ultimately personal to people's future). Thus, changing the narrative from an annual cost cutting exercise, to one of longer-term business transformation that creates positive engagement for employees.

2. **Understand your start point and how to measure progress.** Fundamental perhaps but too often organisations are unable to truly grasp what makes up the cost base. Allocations processing by finance departments slice and dice numbers that ultimately become too disconnected from the reality of the cost base. And with this cost often allocated to various users, entities and regions within an organisation, this fragmentation effect can make the entry point for the benefit case unclear. As a result, the transformation exercise lacks a basic grounding in what drives its cost. Most organisations lack measurable insights into how workload effort and cost is distributed across their post trade environment, with process fragmentation across regions (and in some cases vendors) making the true picture hard to assess.

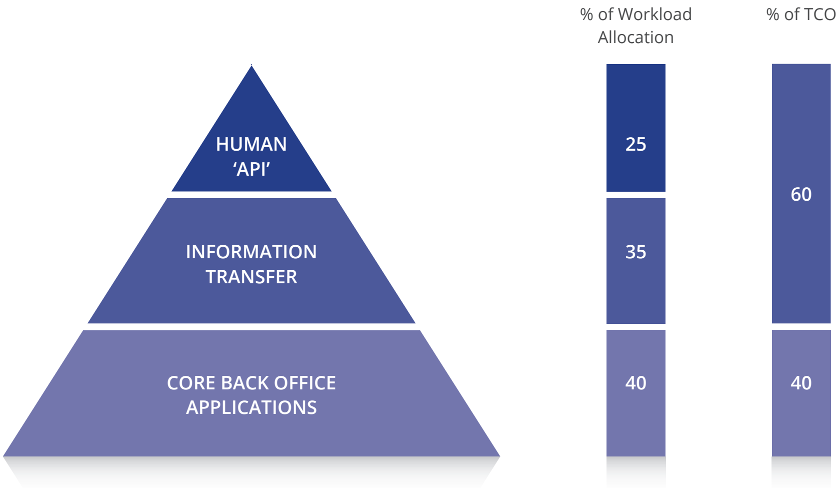
   Traditional top down metrics for justification of transformation need to be re-thought to drive a material economic outcome. McKinsey and others have long championed the value of zero-based budgeting for organisations looking to develop sustainable cost improvement. One of the keys to success of this approach is taking a bottom-up view of cost – *'what can the business sustainably afford'* vs a traditional top down approach of setting percentage driven targets and hoping for the best. Given the criticality of the C/I ratio challenge outlined earlier, the start point for the benefit case must be based on affordability – for a base level of income, what is maximum level of cost?

   Once this start point is clear, this then sets the mandate for the programme to explore solutions to drive towards this given level of cost. The benefit case is then developed alongside this goal with a clear objective – C/I ratio sustainability as an obvious example – rather than the challenge of justifying investment based on short term ROI horizons. This latter approach typically only leads to tactical, short term approaches to cost reduction which are insufficient to solve the problem.

   Integrated into this benefit case must also be a broader view of inputs as opposed to merely seeking bottom line cost reductions. The perspective of the cost base has to be forward looking in the sense that it can incorporate aspects such as future cost of change (cheaper and easier vs the current state), speed of change (an enabler of business growth and regulatory compliance), the client experience (revenue retained or gained through enhancement) and reduced risk profile (fewer key person dependencies, improved resilience and recovery). All these inputs must be considered and modelled credibly to give value to support transformational change. This change will not be overnight – greenfield system development may not be practical to integrate into an ongoing business – but that is not to say greenfield thinking should be ignored. Thinking differently must be the start point for the transformation to succeed.

3. **Re-think your operating model to match the business of today and tomorrow, not yesterday.** The current way of working is unlikely to be a highly optimised one for your current business. More likely it represents a layer-upon-layer build-up of tactical solutions created to support a historically broader and bigger business offering. And though business restructuring or rationalisation may have focussed on obvious, direct costs this will in all likelihood have neglected the legacy cost of the post trade environment. This needs to be re-aligned.

   Cost realignment will only be successful if the operating model is designed to support the business of today and tomorrow, enabling cost and redundant complexity to be removed. The reality of this complexity can be seen below, in a visual example of what we consistently identify when talking with clients.



*Total Cost of Ownership of people and IT

   Business evolution over time has built up layers of process complexity within post trade infrastructure – where lack of business standardisation, tactical responses or technology limitations have created a cost structure dominated by three main themes:

   – 'Human API' where manual processes are standardising data to enter the infrastructure. Offshoring and/or third-party sourcing has historically been a quick and scalable option for banks to add people into the process to avoid investment in automation.
   – 'Information Transfer' which covers the vast volume of emails, spreadsheet exchanges and phone conversations both internally and externally to validate trade and data integrity.
   – 'Core Back Office Applications' which are systems that cover the standardised processing of trades.

   And whilst back office applications (think settlement, data or corporate actions systems) have historically attracted significant investment, they have actually only focussed on 40% of the cost – leaving the rump of the cost base untouched and transformation efforts ultimately frustrated. This has been caused by organisations attempting to invest money in middle and back office automation but lacking the insight of the 'as-is' operating model as cost drivers and more importantly, the 'to-be' operating model. This fundamental disconnect is why the cost of post trade is, for many, so high as a significant proportion of the cost base is untouched by investment efforts. It is this lack of understanding that historically has led poor investment decisions, with significant spending being made in the wrong place.

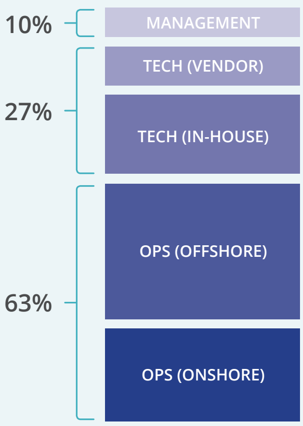
   This type of insight can be gained practically by people who understand the post trade process – it doesn't need an expensive third-party activity based exercise to deliver it. One organisation we spoke to leveraged in-house desktop monitoring software to detect usage of core apps vs other toolsets, which gave a baseline for further analysis. It provided a quick entry point to the discussion without a cost-justification mentality from process owners colouring the output.

   Such analytics allow management to identify the key process inefficiencies that the new operating model must address. And it is this redesigned operating model that becomes critical to move forward with transformation initiatives.

4. Align technology to the operating model, not let it define it. Too frequently, technology is disconnected from the target operating model leading to failure of transformation efforts. This misalignment of investment ends up with an application focus – *'lets replace system a with vendor b or c'* as opposed to reimagining the value chain to support the overall objective. And to truly deliver the transformation outcome, this has to be tied to the progression of the operating model in terms of what role (and cost) is associated with people in the process.

We undertook some research into the corporate actions process on behalf of one of our clients, to develop an understanding of the cost distribution within the process. This processing area has seen significant investment in technology over time, through both in-house system development and vendor system deployment. The analysis highlighted however that despite this investment, the overwhelming majority of the cost base continues to be made up of people. Showing that despite significant investment into technology, low levels of automation persist throughout the process. An whilst some may argue that lack of standardisation is the real driver for this, we see this an example of where technology investment has failed to solve the business problem by leaving the majority of the cost base untouched. As in reality, the investment has become disconnected from delivering the business outcome.

TCO For Corporate Actions (2017 Analysis)



This analysis assessed the make up of the cost base (TCO) across a sample set of sell side institutions and custodians

By driving your technology roadmap from the target operating model, this creates clarity around what roles the organisation performs – these could be to support client service, new product innovation or risk oversight – and the role that technology needs to play. This alignment ensures that technology is driving the business outcome, not delivering automation in isolation.

5. Leverage external services – mutualisation is the key. The maturity and evolution of the fintech landscape has been significant over the last 5 years, with newer technologies emerging with credible use cases to support the transformation agenda. Succeeding in the objective of material cost reduction will only be realised through greater adoption of technology, but this adoption must be focussed on enabling the future state operating model. Technology is not a strategy in itself and where this disconnect arises between IT and the operating model, investment becomes mis-placed. Mutualisation of cost and investment is a key objective for the industry, where duplicated spend internally for R & D and regulatory compliance has become a significant drag on cost over the last decade. And to deliver this level of cost efficiency, the future for post trade must focus on adoption of external innovation, leveraging cost mutualisation via utilisation of managed services underpinned by cost efficient, scalable hosting solutions. These services however must be blended into the legacy architecture that will persist internally in some shape or form – so creating a roadmap sympathetic to the legacy of the past but also able to look forward is essential for success.

Adoption is not without challenges, as effort is needed to create the levels of data standardisation that are required to support a service orientated architecture. But this investment has to be made to deliver the sustainable platforms and processes for the future of post trade – and complexity can no longer be an excuse for retaining technology in house.

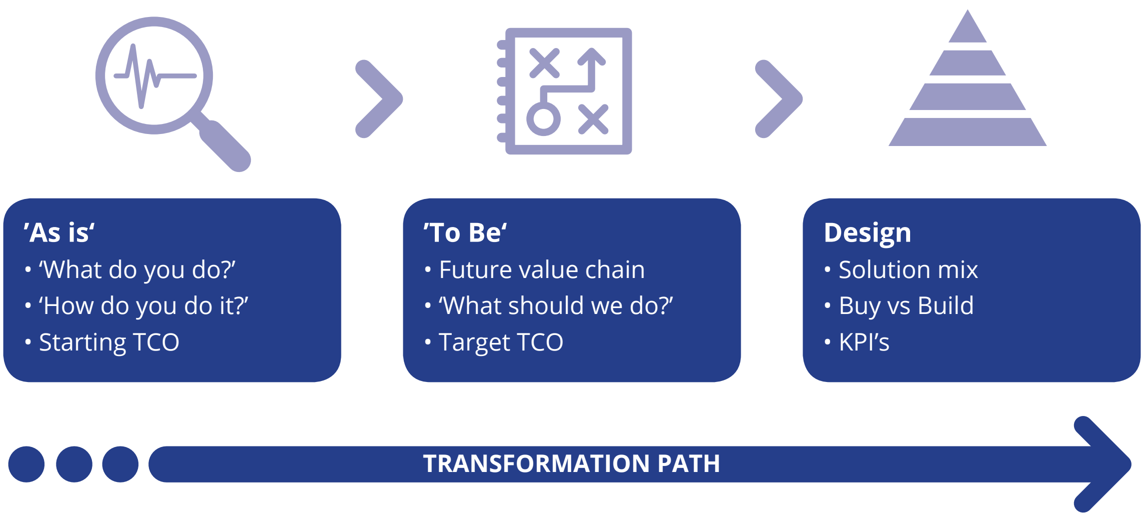
6. **Change governance must be robust.** Alongside sponsorship and ownership of the vision, change governance is ultimately critical to the outcome. This continues to be overlooked by many organisations, who misunderstand the level and skills of resourcing required to deliver these types of transformational outcomes. In cost-conscious environments, it becomes too convenient to label transformation responsibility *'part of everyone's day job'* implying shared ownership but in reality, avoiding cost. This typically results in failure, as without the dedication of resources who understand the legacy environment alongside disciplined programme management teams, little progress is made.

   Transforming the legacy built up in post trade architecture is hard – that is why it remains unsolved by many – so recognising this organisational complexity and resourcing appropriately is key to success. And in guiding the execution team, the role of the sponsor(s) becomes critical. Steering committees need to be visible, active and accountable for the outcome – and stakeholders need to be fully engaged and supportive of the objectives.

7. **Bringing people on the journey.** Cost reduction generally has created fear of uncertainty internally for most organisations over the last decade, as the result of these agendas was for people to lose their jobs. The reality is that to transform the operating model, people will be the drivers of a successful outcome (technology is only the enabler) and as such need to understand how and what role they will play in the future. For organisations looking forward into the next decade, they must recognise the role people will play on the journey – and the role they will play at the destination in the future operating model. By doing this, skills can be nurtured, valuable institutional knowledge retained and leadership can focus on delivering the future.

By focussing on these seven themes, organisations can be impactful in delivering material changes to their bottom line. We believe that focussing on operating model redesign and leveraging modern technology can deliver 30-40% reductions in post trade cost – ***but to succeed, organisations have to think differently around how they address the challenge.***

Transforming *legacy* architecture... conceptually simple



... but execution made complex by *legacy* business behaviours

How Ascendant Strategy can help transform your post trade infrastructure?

At Ascendant Strategy, we recognise that every organisation is unique – your 'legacy' is different from everyone else's – and so our approaches reflect that. And we use the word 'approach' very deliberately to highlight that we don't repackage standard methodologies, frameworks or solutions from other places to force-fit them to your problem. We bring credible and tested approaches that fit the culture, size and change maturity of your organisation, with a focus on delivering practical, tangible outcomes. Our teams are experienced practitioners who have sponsored, led and driven transformation across capital markets. We respect complexity, but we don't let it block the outcome.

Strategy Development & Definition

We have extensive experience in translating organisational objectives into practical post trade strategy. Creating this connection and then delivering the roadmap for transformation is easy to say but complex to deliver. Our approaches enable us to quickly determine where you are and where you need to get to, leveraging techniques such as target operating model redesign or digital enablement to deliver your outcomes. As an example, we delivered the post trade strategy to drive back office technology re-platforming at a European bank, where IT had budget but no direction. This utilised current state assessment, value chain definition and target operating model design to support definition of the future state IT architecture.

> *"Thank you for the work you did to get us to this position, it was extremely valuable"*
>
> **Global Head of Operations, Finance and Risk Technology, European investment bank**

Change Management Execution

Our teams match change management best practice with the capabilities and maturity of the client. This enables us to quickly define a framework that fits the resourcing and needs of the task at hand, rather than imposing people and methods that may not be needed. Leveraging our $8P^2$ approach to change management, we can assess, monitor and lead you to a successful outcome.

> *"When Ascendant Strategy came on board, they told us exactly where and why our project was stalling. They followed this up by establishing a strong project framework, advising on resourcing, and developing our staff with the benefit of their extensive operational knowledge. Ascendant Strategy is a thoroughly professional and highly experienced firm"*
>
> **COO at G-SIB**

Fintech Enablement

Through extensive experience leading transformation efforts inside capital markets organisations, we have developed unique insights into how to deliver successful outcomes. We complement these insights with 'outside-in' thinking from the Fintech landscape, providing strategic direction and practical advice around how to leverage external innovation to drive transformative results. This blend of expertise is invaluable for both capital markets clients and technology firms, to enable credible and pragmatic solutions to a problem statement.

> *"Ascendant Strategy over-delivered against the brief and exceeded my expectations significantly. They have disrupted our thinking and made us look at different architectures for moving forward"*
>
> **MD Markets Operations, UK Bank**

Take control of change, with a partner you can trust.

If you need to deliver complex transformational change with fast positive impact, contact us today

Visit **ascendant-strategy.com** for further information
Email us at **contact@ascendant-strategy.com**