Outlook 2022

– Who Will Make The Post Trade ‘Quantum Shift‘ In Capital Markets?

Jan 2022

Strategic. Evolutionary. Practical.

Outlook 2022
– Who Will Make The Post Trade 'Quantum Shift' In Capital Markets?

Twelve months ago, the world emerged from the initial impact of the pandemic and the financial services industry assessed how it fared. Market volatility had driven bumper returns for much of the industry, concerns around defaults had broadly been unfounded and one interesting by-product of the global lockdown had been a forced acceleration of digitalisation agendas. 2021 heralded an opportunity for change, to push forward with digital transformation as the world optimistically targeted the 'new normal' within capital markets.

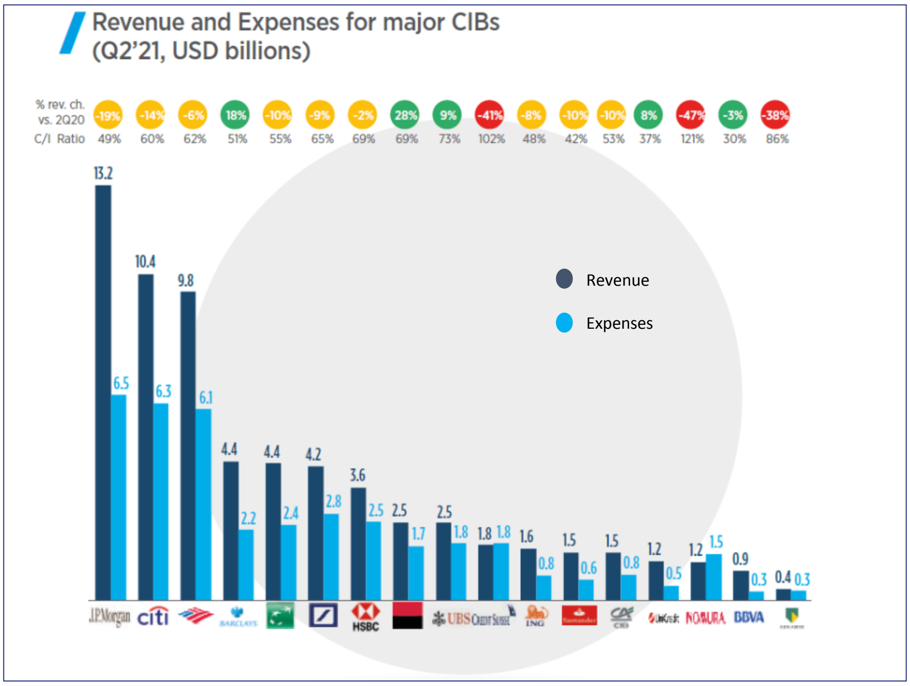
The reality has been that this new normal didn't quite materialise – further uncertainty created by Coronavirus impacted planning, regulatory scrutiny increased and the reality of legacy technical debt made delivery of digital agendas a challenge. Markets remained buoyant but the structural challenges that stymied transformational progress continue to persist.

The pandemic shook off some of the inertia that has dogged the capital markets industry, but many organisations are still hamstrung by the inefficiency of their front to back operating models. Whilst a decade of regulation and electronification may have streamlined the front part of business models, for many their middle and back office has arguably become more complex and expensive to run. However, for those that are opportunistic, the environment in 2022 can support a 'Quantum Shift' to transform business models. One we believe can be material in terms of cost – 30-50% reductions in TCO – whilst also bringing significant benefits in terms of agility, risk management and customer outcomes. Here is why and how.

What did 2021 signal for capital markets in 2022?

Industry Economics

Industry revenues started to normalise throughout 2021, as market conditions returned to levels similar to prior to the pandemic. Although banking continued to deliver outsize returns (per Tricumen[1] analysis, in M&A 'Banks' 1H21 fees surged 40% y/y, and profits 80%'), this represented something of an outlier as reduced trading activity put pressure on the economics of capital markets firms. And per analysis from Eurogroup[2], most organisations saw a levelling off of revenues vs 2020, (even with banking revenues propping up a lot of performances). Tellingly, more than half of the organisations within their sample set posted cost-income ratios of over 60% – highlighting their vulnerability to further revenue declines.



With the assumption baked in that the 'purple-patch' for banking tails off (Tricumen forecast a base assumption of 20% reductions in the latter half of the year), it shows that revenue performance will come under renewed pressure. This is telling particularly for those outside of the bulge bracket global players, whose economics make them vulnerable to a downturn. Namely, a relatively fixed cost base with relatively high cost/income ratio.

Regulatory Backlash

Though sympathetic in 2020 to the plight created by the pandemic – with regulations being delayed to allow organisations to focus on stabilisation – regulatory pressure returned in 2021 with clear messaging from supervisors across the globe. The CFTC handed out fines to the likes of Mizuho and Soc Gen for reporting infringements, Deutsche Bank was fined by multiple regulators (BaFin, SEC) for various control failures and the FCA fined HSBC, Natwest Markets and Credit Suisse over £475m between them for various control and AML failures.

[1] CIB Review 2Q21/6m21Tricumen, August 2021
[2] CIB OUTLOOK 2021, Eurogroup Consulting, November 2021

UK supervisors also issued 'Dear CEO' letters to the industry over transaction reporting and equity financing respectively. The tone of both contained clear messaging, tinged with frustration. For regulatory reporting, this was driven by the output from 166 reviews that had been conducted since 2019 and highlighted trends around governance and investment in data integrity and controls.

'Overall, we were disappointed to find significant deficiencies in a number of firms' processes used to deliver accurate and reliable regulatory returns. It was clear that multiple firms did not treat the preparation of their regulatory returns with the same care and diligence that they apply to financial reporting shared with the market and counterparties. For some firms, there had been a historic lack of focus, prioritisation, and investment in this area.' [3]

Where equity finance was concerned, this was driven out in response to the Archegos default, which had material economic impact to some of the banks involved. Part of this messaging was again frustration around lessons not being learnt from 2008, where some of the themes around liquidation of collateral and risk management have re-appeared as part of their review.

'Many of the deficiencies set out in this letter are not new and have been observed before. In particular it is highly concerning that lessons from the Global Financial Crisis have not been learned sufficiently and that necessary changes to business and risk management practices have not been embedded in firms' operations.' [4]

Alongside these focus areas, the pandemic also drove action around the robustness of operational resilience across the industry. Whilst the UK supervisors have probably been most prescriptive around actions and dates, both the US agencies and the EU commission have come out with broadly similar messaging, which also aligns with principles outlined by BCBS. The bottom line being that whilst the industry demonstrated a level of resilience through the pandemic, lessons learned from that experience must be taken forward. Proactive monitoring of key business processes and services, supply chain management and ongoing scenario/stress testing will need to become focus areas for the C-suite. Not delegated downwards to functional departments.

Expect supervisory focus to heighten in 2022.

The Unfortunate Reality of BCBS 239

Data continues to be a significant challenge for all capital markets players, who despite efforts to comply with the principles outlined in BCBS 239 have not materially moved the needle on data management. In its report in April 2020[5] , the committee reported that 9 of the 34 GSIBS were still 'materially non-compliant' regarding data architecture and IT infrastructure (Principle 2). And no bank was classed as being fully compliant.

Banks appear to have focussed on the non-technical parts of implementation – such as governance – but had neglected to make the relevant investment in data or IT architecture to become fully compliant. The relevance of this is that whilst the framework created an opportunity for transformation of legacy technology and remediation of in-house data challenges, failure to capitalise on this has left most organisations (GSIB's and others) with sub-standard data architecture. This adds cost to their operations – think data integrity checks, reconciliations, manual report compilation – but more importantly, creates a significant blocker to innovation.

[3] Dear CEO letter Thematic findings on the reliability of regulatory reporting (bankofengland.co.uk) September 2021
[4] Dear CEO Letter: Supervisory review of global equity finance businesses (fca.org.uk) December 2021
[5] Progress in adopting the Principles for effective risk data aggregation and risk reporting', Basel Committee on Banking Supervision, April 2020

Whilst industry standards make adoption of third-party services conceptually straightforward, the reality is that these actually become layered with complexity as poor data requires complex translation processes to support adoption.

What in 2015 was viewed as yet another regulatory burden has, in hindsight, been a missed opportunity for organisations which made tactical responses to comply rather than drive a fundamental re-think of the role of data within their architecture. Failure to deliver on this now creates multiple challenges for senior leadership, creating increased risk of regulatory sanction (as outlined above) but now also acting as a blocker to enabling innovation. And this is one of the key reasons why the industry momentum towards digitalisation has stalled, as the stark reality of the challenge data creates has become clear.

Shifting Market Dynamics

Against the backdrop of the pandemic, the dynamics within the marketplace have also started to shift as the industry takes stock and pushes ahead with modernisation agendas. Some of this is a direct reaction to certain challenges that have arisen – such as the 'Meme' driven volatility in certain US stocks – but some of this is also the increasing realisation that technology has the capability to transform the way markets operate.

1. Compressing Settlement Cycles. Whilst blockchain and DLT have clouded the narrative around market infrastructure transformation (it should be viewed as just another technology that can enable change, not a change in itself), there is no denying the value that shortened settlement can bring to market. The strongest push is coming from the US, with DTCC driving forward towards T+1 both as a response to some of the recent volatility (such as Gamestop) and also recognising the efficiency benefits in capital and risk that this provides. Some FMIs believe that this reduction could be as high as 60%, which is material when considering some of the challenges that new capital requirements under Basle IV will create for the industry[6]. The challenge of compression to T+1 is as much about sub-optimal processes (requiring people and time to perform them) as it is around the technology that supports market infrastructure. This will require industry-wide focus to make progress against given the DTCC is already signalling a 2023 completion date.

2. Regulatory Refits. The CFTC continue to push forward with revisions to the existing reporting framework, currently targeted for May 2022 (though some delay is anticipated as the industry continues to lobby for more time). The EMIR refit continues to be an area of focus for regulators in Europe and the industry watches closely to see the first big test since Brexit, to understand whether the FCA diverges with the ESMA requirements. Even slight changes will in all likelihood drive duplicative operating models and add further complexity to the process. And though SFTR is still bedding in, there is a widely anticipated EU Review expected during 2022 that will focus on lessons learned and push for broader changes. In Asia, the JFSA continues to push ahead with their rewrite efforts from rules first implemented in 2012. Whilst MAS and ASIC also have plans to review these rules that have been in place for some time, in line with the practice followed by other regulators[7].

So, what does this mean in practice? What is clear is a trend of regulators recognising that the rules put in place post the financial crisis require revision and modernisation, taking into account industry feedback around improving the accuracy and data integrity. And as noted previously in this article, regulators are taking increased interest in reporting integrity and using the full range of sanctions available to them to drive change.

[6] SECURITIES SERVICES EVOLUTION – Disruption and transformation in financial market infrastructures', Citibank 2021
[7] Quorsus Regulatory Reporting Newsletter, issue 3, December 2021

3. The Role of Digital(ised) Assets*. Digitalisation of assets has continued apace, both for currencies (through various initiatives such as CBDC development and utilisation of fiat currencies) and increasingly now for securities. In our outlook paper from 2021, we discussed the increasing emergence of use cases within the FX space, where digital representations of cash were being leveraged to support post trade efficiency. And these have started to gain real traction with the likes of Baton expanding their network recently, claiming the world's first non-CLS PvP settlement between two banks.[8] HQLA[x] also continues to gain traction, through leveraging a similar concept to create a digitalised representation of securities to improve collateral mobility.

Alongside these initiatives have been successful completion of actual tokenisation of both cash and securities – such as Project Jura[9] – which has more far-reaching implications for the capital markets landscape. Though slower in terms of progress (due to the cross border and process complexity), they start to demonstrate the value that could be realised by longer term tokenisation of assets and how this can improve settlement cost and efficiency.

And what can't be ignored when discussing digitalised assets is the growth of crypto-assets, both in terms of trading and custody services that institutional investors are increasingly looking to access. Creation of access products (such as ETP's or ETF's) continues to grow as investors take increasing interest – assets in European crypto ETP's and mutual funds had topped €10.5bn by November 2021[10]. And the revenues for servicing crypto assets are forecast to have grown to $9.4bn by 2030 (up from $671m in 2020)[11]. Irrespective of the progress around regulation of this sector, the opportunities this market growth creates for all capital markets participants ensures that it will be high on management agendas throughout 2022 and beyond.

Innovation No Longer Just for Early Adopters

The significant growth in technology maturity has meant that transformative solutions are no longer reliant on having a high risk/return mindset around adoption. SaaS offerings now provide a commoditised, cutting-edge alternative to legacy technology whilst bringing innovation at a competitive price-point. Add in the value of standardisation that these solutions typically bring, mutualised investment in product enhancement and futureproofing ongoing compliance requirements and the benefits become increasingly hard to argue against. Further, the barriers to integration – 'Too costly to implement a new solution into our infrastructure' or 'We always overrun on implementation of new solutions' – are also starting to fall as sophistication of data translation layers and API accessibility make 6-12 month implementation timelines credible.

Fintech is no longer just for organisations with in-house innovation labs, it has increasingly become a commoditised product that is available to all players in the capital markets eco-system. And as importantly, is commonly available at a price-point that makes adoption compelling. The level of competition across most post-trade segments is high, which ensures that single vendors do not dominate the market. This competition is good for all, as it encourages new entrants to the market and stimulates innovation but also gives buyers comfort that they will not be held captive by a monopoly supplier (which has not always been the case when buying post trade software). Interoperability and 'adopt and drop' capability is increasingly becoming an important topic with our clients, who want to ensure that portability of vendors is factored into any decision making.

As Fintech continues to attract record levels of investment, the market for services will continue to evolve as technology innovation is applied to post trade challenges.

* Digital(ised) assets refers to the full spectrum of DLT enabled assets, from digital representation of existing assets, fully tokenised assets and crypto assets.

[8] Baton Claims World First with Non-CLS PvP Settlement – The Full FX, December 13th 2021

[9] Project Jura – Cross-border settlement using wholesale CBDC (bis.org) – December, 2021

[10] Popularity of crypto funds sparks growing interest from managers, FT November 23rd, 2021

[11] Crypto Asset Management Market, Allied Market Research, July 2021

How to deliver the 'Quantum Shift' to business models?

Data-Centric Evolution

The post trade environment across capital markets, where many of the process challenges are problems that cannot be ignored and must be fixed, does not offer a "blank canvas" or "greenfield site" from which to start transformation.

But adopting data centricity – loosely, an architecture where data is permanent and the primary asset whilst applications come and go over time – can be the catalyst for organisations to bring in greenfield thinking to their legacy architecture. Not only does this provide a platform for innovation, but is increasingly going to become a critical part of senior managers agenda going forward.

Why do we think that?

Because the failure to systemically solve the data challenges that persist across all capital markets players – both large and small – is increasingly going to hurt business models. Firstly, regulatory frustration with an inability to solve for data integrity challenges is ultimately going to hit the bottom line. This will come either in the form of direct sanctions (the CFTC issued 5 separate fines to various market participants in this regard in September 2021 alone) or will make its way into capital add-ons and increased supervisory oversight. As noted earlier, the example of the tone set by UK supervisors is one of frustration that prior lessons have not been learned in this regard and so would expect this to be a frequently discussed topic by capital markets players and their supervisors going forward.

Secondly, this lack of data centricity persists the costs and complexity of legacy system architecture by making it increasingly difficult to adopt and integrate new solutions and services – information is trapped in "data jails". We note some organisations moving forward in this regard, recognising that basic ROI metrics will not justify the spend but it is a necessary enabler for longer term efficiency and enhanced control. Investing time in assessing some of the basic considerations that BCBS 239 proposed – the roles of ownership and stewardship, the value of data dictionaries, the governance around implementation of standards – should be an area of focus to understand how architecture can be aligned around data. Not defining it.

Leadership must address this challenge, as continued layering of tactical responses to business challenges will only make this complexity harder to unwind.

Mandate Collaboration

The fundamental challenge for post trade processing is that there are always two-parties – at least – to every transaction and lifecycle event. Not matter how efficient one of these maybe, this benefit is pretty much negated if the other party involved does not operate in the same way. The uniqueness of most capital markets players in the way that their systems and processes are configured makes unilateral efforts worthless, given that the other party will also need to mirror these efforts. To do this bilaterally is impractical, given the spread of counterparties that each organisation will typically work with. The symptom of this issue is the rash of email exchange containing two (generally unstructured) versions of transactional or other data. This is a major driver of manual work, which makes the need for industry wide collaboration key to resolving some of the inherent inefficiencies in post trade processing.

Whilst industry forums have historically tried to push some of these collaborations, the reality is that this needs to be driven by organisations that can also provide solutions to these challenges. This is difficult for an industry forum to progress, who typically need to maintain some sort of independence from provision of third-party services. And consensus amongst members around how to proceed can also be challenging to achieve.

FMI's have historically led the charge in driving some of this collaboration (think TriOptima as a reconciliation tool or Acadiasoft for margin management), but this has typically been in helping the industry respond to specific regulatory driven change as opposed to delivering post trade automation. Nevertheless, this experience shows the value that collaboration can bring as organisations migrate onto their services and realise the benefits of working on a common platform with their clients and counterparties.

But FinTech's have emerged with solutions to these challenges, recognising the need for a solution to be made available to the market that can support collaboration between market participants to solve common challenges. The likes of Access Fintech – with their common exception management platform, where issues can be resolved between counterparties – and Taskize – who remove reliance on point-to-point email communication to bring the right organisational groups together to resolve exceptions – have created solutions that make this collaboration easier. And as critical mass develops on these types of platforms, organisations will be able to reduce cost and improve efficiency by retiring their bilateral working practices.

By adopting these services, business models can start to move away from the legacy complexities inherent within their systems and process, which add cost and limit agility. This 'adopt and drop' approach is a key enabler for the future state of the capital markets industry, where collaborative solutions are able to solve common problems for the industry. And who knows, it could be the catalyst for simplification of internal inconsistencies.

Embrace Standardisation

The industry has no shortage of standards; SWIFT has been operating since the late 1970s and the FIX protocol that has been around since the 1990's. More recently, FDC3 has been at the forefront of pushing application interoperability and the CDM that has been designed through ISDA is starting to help de-clutter OTC derivative processing. All of which can be powerful innovation enablers when adopted by organisations.

But the challenge for adoption is less around the availability of data standards, it is much more around how organisations can apply them to drive standardised processing. Many organisations maintain expensive point to point connections between themselves and third-party service providers, where extensive manipulation or mapping of data is required to bring information into and out of their infrastructure. This is not only expensive to maintain, but also limits connectivity to solution providers where data translation requires expensive in-house efforts to implement – and typically, is constrained by a finite resource pool.

But this shouldn't be a limiting factor – many solution providers will solve this for you tactically ('just give us your data and we will translate it for you' is not uncommon from vendors who recognise this can accelerate time to market). In the medium term, this will require organisations to focus on the value of data centricity outlined previously. Biting the bullet will unlock cost and inefficiency but does not necessarily mean a repeat of the long tenured programme that BCBS239 ended up being for so many. But it does require sponsorship to drive forward, delegating this to data officers or cross-functional constructs will not create the momentum required to solve the problem.

Evangelise The Role of Technology

Most post trade leaders and owners have recognised the increasingly important role that technology will play in the future of their business models. The need for democratisation of technology – bringing process owners closer to technology decision making – is key to ensure that operating models are optimised. And with the Fintech industry offering commoditised solutions that solve common problems (such as the use of email as a workflow tool), it is critical that a 'tech-first' approach to middle and back-office processing is mandated. For much of the last decade, outsourcing has provided an easier route for cost reduction than addressing legacy technology challenges that were deemed too complex to fix. And whilst these have provided short term cost benefits and brought scale to the operating model, they have not addressed the process complexity that has continued to build up over time.

We consistently find within our work with clients that for many, more than 60% of their post trade TCO (across operations and technology) is made up of people – and for some, this number is much higher than this. This isn't a reflection on technology being cheap or efficient, it is a by-product of relying on people to compensate for process complexity.

With the emergence of intelligent automation, cloud-deployable SaaS solutions and the growth of collaborative third party innovation referred to earlier, this should no longer be a position that institutions find themselves in. But this realisation and the challenge to do things differently must be led from the top. Hoping that this will happen organically will not deliver the results required.

Plan for Digital(ised) Assets

Whether this is merely thinking about how to connect to platforms that can bring post trade efficiency– such as Baton by digitalising representations of assets – or connectivity into managed services that can enable settlement of digitalised assets – such as Paritar – the reality of taking a 'wait and see' approach is rapidly become unviable. The momentum around how DLT as a technology catalyst is disrupting the post trade landscape, the progress of both CDBC currencies and also tokenised securities, as well as the increasing emergence of crypto as an asset in its own right poses fundamental challenges to current state post systems and processes. In some sense, this shift will be so stark that it will ultimately force institutions to dual-track their infrastructure – as historic complexity makes consolidation of digitalised assets alongside traditional processing impossible. This will be the worst of both worlds, whereby the benefits of the new world become eroded through lack of synergy with the old.

Whilst these changes may seem far away, the pace of growth within this space is rapid and as benefits of adoption become evident, organisations will be unable to pivot quickly enough. Proof of concepts have moved through to proof of value, with early adopters already making moves to offer services. Given the pace of change, organisations should be focussing upon how they plan to integrate these asset flows into their infrastructure, how this will impact their traditional operating models and what transformative opportunities this market dynamic will bring.

Closing Thoughts – Who Can Make the Quantum Shift?

The pandemic created a fundamental shock to the capital markets industry, one which it weathered much more effectively than the crisis of 2008. But although this was a positive outcome, the industry continues to be at a tipping point where technology-led transformation will eventually disrupt the established group of current market players. We believe that the current dynamic within capital markets makes this increasingly a matter of when, not if, this shift occurs.

This 'Quantum Shift' will be driven by organisations that embrace the opportunity that data centricity and new technology will bring. They will be **collaborative** and heavy adopters of third-party services, **leveraging a data centric architecture to 'adopt and drop' technology that will be transformative to their operating models**. They will leverage this to cut out legacy complexity, **delivering 30-50% reductions in their TCO** whilst increasing elasticity within their cost base. This will make them less vulnerable to market conditions and more agile to capitalise on opportunities as they arise. As they free themselves from the shackles of legacy complexity and challenges associated with "data jails", they will also find second order benefits. **Costs of change reduce** by the shift of emphasis onto third parties to develop and test enhancements, freeing up resources for value-add activities. **Improved data integrity creates trust internally**, where true golden sources of data are used to fulfil internal and external obligations to stakeholders (such as clients and regulators). Availability of consistent, standardised data will bring further benefits to leadership who are able to truly become data-driven in their thinking. Leveraging these insights for stress testing and scenario modelling across key business services will help drive focus and investment to key pinch points, whilst also giving comfort to regulators that they have a robust framework for measuring their operational resilience. And criticality, **they will be positioned to deliver an enhanced customer outcomes at a lower price point than their peers**, which will ultimately enable them to increase market share.

Making this leap may sound a far cry from the current state environment that many organisations find themselves in – but is one that many have already made within their front office environments. Mass electronification has greatly simplified this domain and led to dramatic cost reductions for most franchises as technology and data driven thinking have replaced traditional sales and trading roles. This shift has not happened across the post trade environment, but technology and industry maturity now make this a viable prospect for those organisations bold enough to challenge organisational inertia. And those that are successful in their transformation will find themselves at a significant competitive advantage to those that don't. The question ultimately becomes for senior leadership, can you afford to wait and see?

Our Philosophy

Post-trade infrastructure is complex and highly bespoke, as a by-product of business model evolution and institutional history – it's 'too big to fix' in one step.

- Traditional transformation strategies underestimate this complexity, attempting standardised platform solutions to 'rip-and-replace' infrastructure in its entirety
- Wholesale digitalisation as a solution becomes challenging, with in-house legacy technology needing to be blended with cutting edge vendor solutions
- Programmes typically end in failure or significant cost-overrun, due to mismatch of solution approach with strategic objective
- We believe that transformation has to be a staged, multi-phased approach, based on key principles:
  - **Pragmatic:** each step must be achievable by all stakeholders
  - **Integrated:** IT and Business processes have to be integrated into a single solution
  - **Results-Based:** tangible programme outcomes to be delivered in each phase
  - **Sympathetic:** recognises competing interests from different stakeholders

We have extensive experience in delivering impactful, transformational outcomes for clients across the capital markets spectrum. Talk to us around how we can support delivery of your goals, working with a partner you can trust.

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

Strategic. Evolutionary. Practical.