ZEB PERSPECTIVE

Turning securities services profitable

How to unlock added value in post-trade operations

partners for change

Key findings

1

Banks frequently overlook the profit potential of post-trade securities operations, because their costs are generally low compared with the overall cost base.

2

Lack of scale, too many manual processes, weak commercialization and outdated IT are the key reasons for poor profitability in middle and back office securities operations.

3

Past profitability efforts have often failed due to a lack of focus on turning securities services into low-cost, "have-to-run" services.

4

Our research shows how they can be converted from underperforming utilities to revenue-generating "banking-as-a-service" operations.

5

By addressing these issues, banks can turn underperforming securities operations profitable.

For a long time, improving the profitability of securities services has not been a major priority for banks, whose primary focus has been on front office costs and revenues. By comparison, post-trade activities account for a relatively small share of banks' overall cost base.

An initial mind shift occurred after 2008, when the average scale of securities services increased, due to the consolidation of post-trading activities between banks and a rise in outsourcing. Yet despite these efforts, the average back office cost per trade among Europe's leading banks has hardly changed in the past 12 years, because most cost-cutting initiatives have failed or been deprioritized.

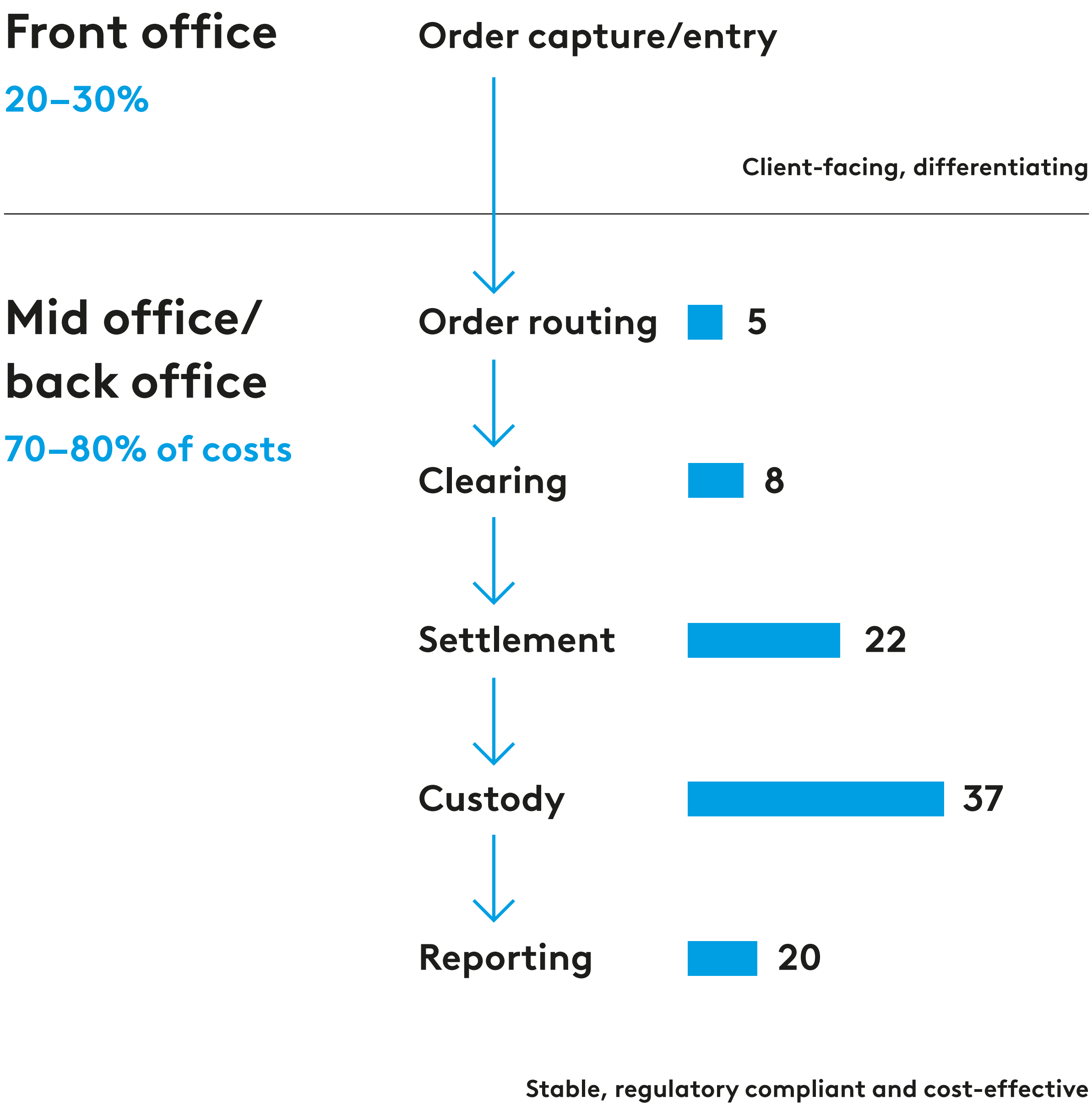
We strongly believe that COVID-19 and the imminent likelihood of a global recession will trigger a renewed cost-cutting and consolidation drive in post-trading activities. Back office costs will be highly relevant to total returns in a banking market under extreme stress.

The measures set out below offer a roadmap for making profits out of flat or loss-making post-trade services such as clearing and custody. Overall, they provide a critical example of how banks can convert costly middle and back office post-trade operations into a reliable, long-term "profit center" as a global recession looms.

We trust you will find this study helpful and informative and look forward to receiving your feedback.

Why banks should care about mid/back office costs in their securities business

Typical breakdown of banks' trading costs, excluding advisory



Stuck in a rut:

Europe's banking securities businesses

Front office activities, without advisory, typically account for only 20–30% of all costs along the securities value chain. By contrast, middle and back office costs account for 70–80% of the total, of which about one-third is taken up by transaction processing and two-thirds by custody activities.

In the current, challenging market conditions, measures to improve profitability should start with these financially burdensome middle and back office services, even though they offer almost no opportunity for differentiated offers to clients.

Until now, most large European banks have merely aimed to keep post-trade operations stable and regulatory-compliant, while neglecting to keep costs as low as possible. Their main focus has been on achieving full front-to-back office integration of the securities value chain with a differentiated quality and range of services.

Meanwhile, medium-sized banks have often relied on the scale and expertise of external specialist providers to deliver standardization, reduction of manual processes and the development of individual services along the value chain. In Europe, leading providers include HSBC Securities Services, BNP Paribas Securities Services, Caceis and dwpbank.

Securities services
Post-trade securities operations and services, such as clearing, settlement and custody, performed internally or by specialist third-party providers

Market focus
EU, other European Single Market member states and the UK

Four steps:

The path to profitability in securities services

So far, neither of these securities services models for large and medium-sized European banks has achieved the anticipated efficiency improvements. Our research has identified four major problem areas which banks have been addressing:

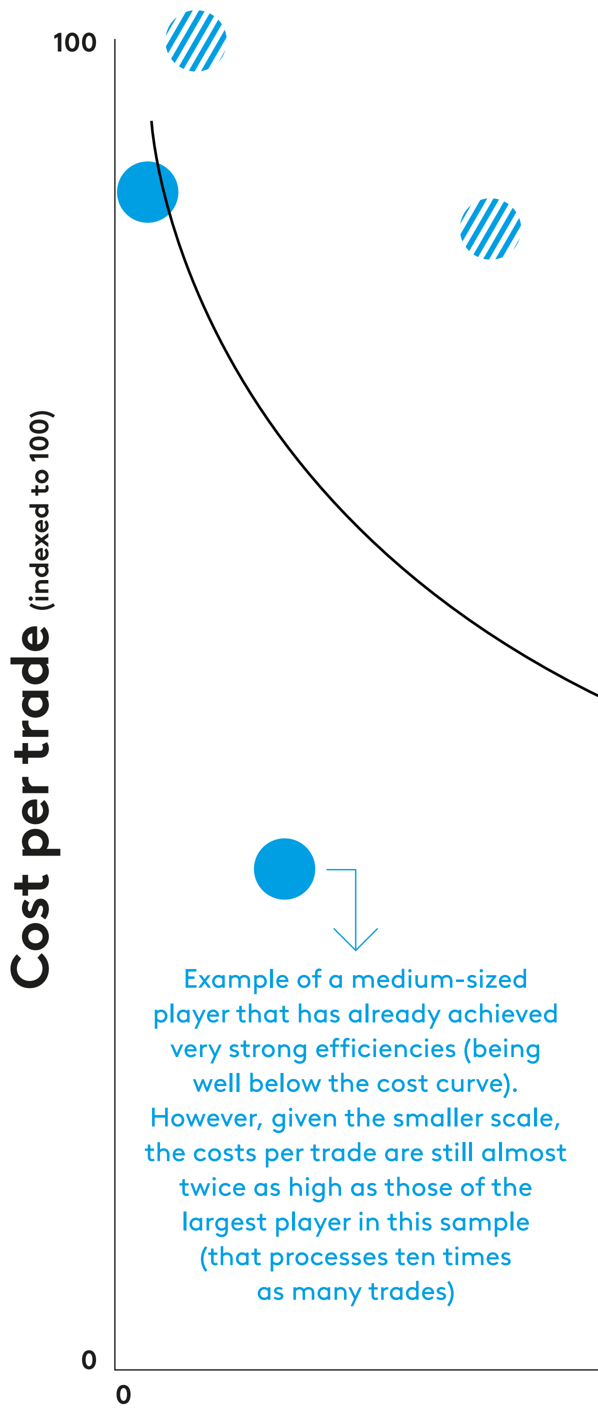
step one scale

step two efficiency

step three commercialization

step four future readiness

In each area, we believe there is significant potential for banks to turn inefficient middle and back office securities services profitable. Banks have struggled to address these problems because until now, board members and senior management have not regarded middle or back office securities services as core businesses.



Step one

Scale—the most important lever

Scale is without doubt the most important area. Relatively high up-front costs mark the main obstacle to outsourcing and consolidation in a fragmented market landscape where many banks operate their own securities services. Sufficient volumes combined with a scalable model make investments into the other three areas more attractive. In addition, they also deliver a significant competitive cost advantage on a cost-per-trade basis, with lower volumes from the start (see below).

For many banks that operate their own securities services, outsourcing offers one route to gaining the crucial benefits of scale. Banks should first and foremost develop a long-term outsourcing model which defines the target benefits. Based on this model, they should standardize outsourced processes to broaden the provider platform and increase transparency. They should also adjust IT systems to reduce complexity and increase flexibility by simplifying interfaces and minimizing applications. In addition, they should reduce the number of Service Level Agreements (SLAs) and decrease interdependent relationships with third-party providers to achieve flexibility concerning a future exit or to switch to another provider.

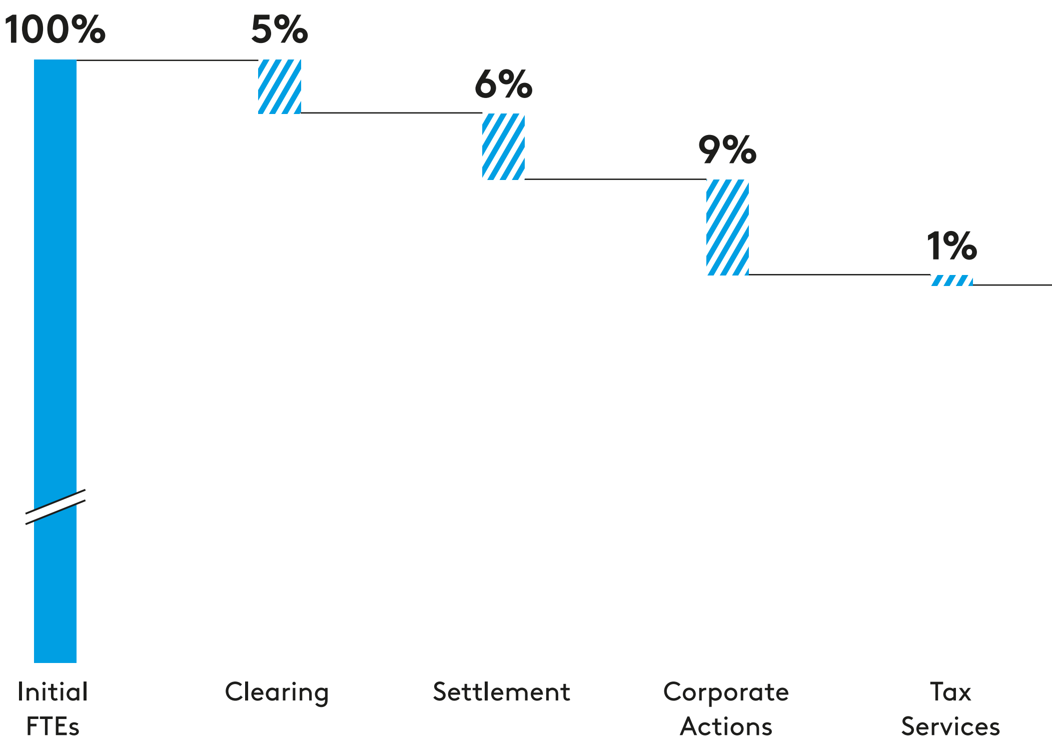
Step two

Efficiency—some call it IT instead

Many banking securities services are inefficient because of multiple fragmented processes with high manual interaction and lack of transparency or because of a poorly managed IT organization. These failings, separately or in combination, create excessive complexity and interruptions. Our research demonstrates that banks can increase the efficiency of their securities operations by more than 25% through rigorous application of a series of measures.

In particular, banks should standardize process variations, deploy specialist and general teams to achieve greater centralization, and automate to enable consistent exchange-to-exchange (E2E) automatic data processing. Meanwhile, they should discontinue time-consuming, labor-intensive services and optimize interfaces to avoid disruptions and media breaks.

Achieved savings in operations by area

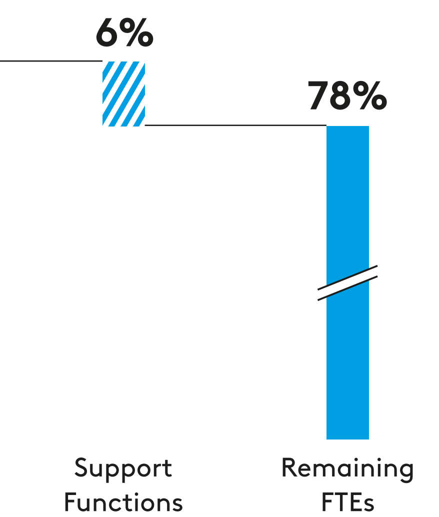


"Many banking securities services are inefficient because of multiple fragmented processes with high manual interaction and lack of transparency or because of a poorly managed IT organization."

Manuel Hobisch,
Senior Manager, zeb

An analysis by zeb of major processes at a leading provider in Germany highlighted several pain points. Capacity savings of approximately 20% of full-time equivalents (FTEs) were achieved after efficiency measures produced a more automated process with fewer variations.

Banks which have already implemented the measures outlined above can achieve further efficiencies through the use of artificial intelligence (AI) for complex business situations such as costly, labor-intensive manual reconciliation and analysis. AI offers enormous potential for improved speed and efficiency by using pattern recognition to perform complex reconciliations that require human judgment. For example, a decision-tree algorithm can identify patterns that match historical scenarios to build a conceptual knowledge based on acceptance and rejection criteria.



Step three

Commercialization—not strictly a cost issue

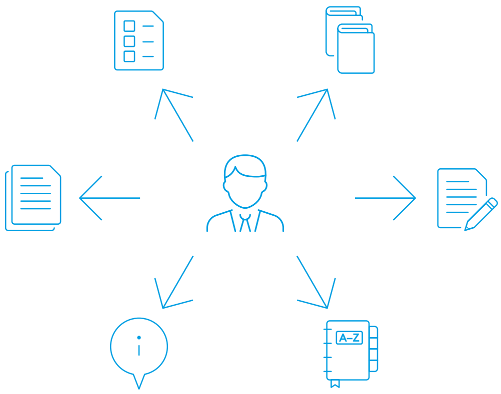
Securities back office services are generally considered a commodity, with limited opportunities for differentiation, market growth or customer movement from other providers, due to high migration costs. This lack of commercialization is another reason for the poor profitability of securities services, even though it is not strictly a cost issue. Core services such as settlement and custody are commonly regarded as “have-to-run” utilities, with limited potential for revenue growth and higher prices. As such, these services only command attention when they are not operating properly.

Additional commercial “value-add” services will give clients the benefits of scale and differentiate post-trade operations from competitors. AI, for instance, can add value to securities services by linking real-time data flows with social media sentiment analysis, allowing providers to offer enhanced sales analytics.

”Additional commercial ‘value-add’ services will give clients the benefits of scale and differentiate post-trade operations from competitors.”

**Martin Rietzel,
Senior Manager, zeb**

Landscape today—huge effort



→ Many open settlements and time differences
→ Some clients differing from market standard
→ Multiple edition of error lists and differences
→ ...

Reconciliation is one of the key drivers of cost and operational risk in the post-trade landscape

Opportunity—AI pattern recognition in data

→ Identification of nettings/pair-offs by client
→ Difference tracking before entry into system
→ In case of errors, specification of efficient resolution process
→ ...

Speed and accuracy can be optimized by creating a machine that analyzes and learns automatically to replace human-based process

Currently, most banks take an isolated approach to analytics, based on frequent, repetitive, independent manual tasks which generate little pre-deal value. This labor-intensive analysis of documentation and legal requirements locks up highly trained professionals who could be deployed more productively. By contrast, AI can develop holistic, real-time indicators and benchmarks such as social media reactions to enhance an asset manager's products. AI-based pattern recognition tools can also identify outliers in trades, such as unsettled transactions.

bit.ly/3jSx5fx

Step four

Future readiness—invest for the future

The severe downturn triggered by COVID-19 means the case for Europe's banks to address underperforming middle- and back-office post-trade operations has never been stronger or more urgent. Turning post-trade operations profitable will boost total returns and ensure future competitiveness against new market entrants and trading technologies.

Banks therefore face a choice. They may decide that it is futile to invest in current IT systems, given the likelihood of overall industry disruption and the possibility that intermediaries may no longer be required in a world of tokenized securities which are registered via distributed ledger technologies based on a blockchain.

Alternatively, they can seek to be competitive in this digitalized market and increase investment in current IT systems. This will achieve the necessary flexibility to optimize processes, keep pace with regulatory changes and provide industry-leading post-trade services and new products for clients.

Based on our research, zeb believes that banks which take the latter route will be best placed to convert securities services which currently function as a utility into a sustainable, long-term profit center. Indecision about whether to replace IT now or wait for disruptive shifts such as tokenization and peer-to-peer trading which could make current systems obsolete is one of the major obstacles to future cost savings.

bit.ly/38zVsta

Many banks across Europe have begun to "grasp the nettle" by addressing some or all of the key issues identified in this report: lack of scale, poor efficiency, weak commercialization and limited future readiness. For example, Commerzbank is currently outsourcing its securities services activities to HSBC, while Germany's DekaBank is just one example of a mid-size bank where a concerted cost-cutting program is underway, including securities services middle and back offices. At the same time, all major banks in Europe's main markets are experimenting with emerging disruptive technologies to be "future ready" for the day when regulators allow entirely new forms of securities services which eliminate the need for third parties.

These examples of good practice point the way forward for other banks which have so far deprioritized middle and back office securities services operations or failed to achieve their cost ambitions. However, there is no one-size-fits-all model for individual players to follow. The most appropriate measures will depend on a bank's existing scale, its business model, and its ability to integrate emerging technologies and systems. Above all, with a global recession looming, banks will require a clear strategic vision of how post-trade securities services can add value.

"Banks face a choice: either wait for a potential disruption with tokenized markets or invest in competitive IT systems that enable efficiency and scale."

**Kai Stefani,
Partner, zeb**

We are partners for change

zeb is one of the leading strategy and management consultancies specializing in the financial services sector in Europe

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