The usefulness of utilities: Survival of the fittest

To be of use is to be a utility. But how many of the new post-crash financial utilities fit the definition? FX-MM's Neil Ainger investigates if they will all survive and cut operational costs, risk and the compliance burden.

The Latin root of the word utility is 'useful' and the Oxford English Dictionary describes the noun as 'the state of being useful, profitable, or beneficial'.

It's a good definition for the rash of new financial utilities now hitting the financial services (FS) sector across financial crime and reporting functions like Know Your Customer (KYC), and in the post-trade and collateral management arena.

"Improved quality and [regulatory] control are the key drivers, as well as reducing the cost of [data] capture and maintenance," says Phil Rolfe, Head of Operations, Shared Services, RBS.

The collapse of Lehman Brothers released a wave of new regulation and increased compliance costs on financial institutions (FIs). The 2008 crash forced them to explore new shared service options and financial utilities in order to cut costs, eliminate duplication, de-risk and improve compliance.

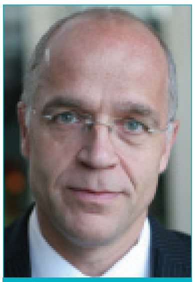
"Volumes across the market are at a very low point, while the amount of new regulations FIs have to manage are raising costs," explains Philippe Ruault, Head of Clearing, Settlement and Custody Product for BNP Paribas Securities Services. "This is occurring in a low interest rate environment, which is compressing margins. It amounts to a perfect storm of challenges for market players [hence the need for utilities]." The number of margin calls required on global markets is also expanding under the impact of new regulation, while operating margins are being squeezed.

Philippe Ruault
BNP Paribas

Getting off the ground

Past examples of successful utilities such as the Continuous Linked Settlement (CLS) foreign exchange (FX) settlement system and SWIFTNet in the global payments system prove the point that utilities can be mutually beneficial for everyone. They're not easy to get off the ground, however, requiring collaboration in non-competitive areas.

The key drivers for the recent popularity of financial utilities can be summed up in two words: regulation and cost – both of which are on the rise. The two are linked, of course, with the cost of just being an FI going up under the Basel III capital adequacy regime and operational expense growing under the weight of multiple compliance demands arising from the European Market Infrastructure Regulation (EMIR) and the US' similar Dodd-Frank rules. These and other regs emanating from the 2009 post-crash Pittsburgh G20 meeting, demand more transparency, 'on exchange'-like OTC clearing and other standardisation and stability measures in the post-trade area. There is also the EU's Alternative Investment Fund Managers Directive (AIFMD) shadow banking rules, MiFID II and numerous other regulations adding to the compliance burden on FIs across all segments. This is why utilities are on the march across all FS sectors.


Alain Raes
SWIFT

The right response

As Alain Raes, SWIFT's Chief Executive for EMEA and Asia, says when discussing the drivers for utilities: "Reducing unnecessary duplication of activities is simply more time and cost efficient." It is often the best answer to the regulation and cost pressures facing FIs.

Examples of new financial utilities either launched, or on the horizon, include the DTCC Clarient Global entity hub for post-trade and the Euroclear-DTCC Global Collateral joint venture (JV), which they're seeking to get off the ground in London to aid collateral management. In the area of KYC there is SWIFT's KYC Registry; Thomson Reuters' Accelus Org ID KYC platform; and the Markit badged, Genpact powered KYC offering.

All of these KYC offerings – and there are other rivals such as the Swiss-based KYC Exchange Net (Ken) due diligence communication platform – have been encouraged by the hefty regulatory fines levied against banks, such as HSBC, that have either broken anti-money laundering (AML), sanctions screening, or suffered similar KYC failures.

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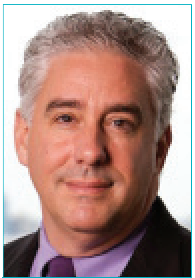
Financial crime rules have also strengthened in recent years as the fight against terrorist financing, rogue nations and criminal proceeds has intensified – often driven by US hegemony. Other regulatory drivers for the adoption of KYC utilities include the supranational US Foreign Account Tax Compliance Act (FATCA) tax evasion rules, which will go global via GATCA.


Tom Dalglish
SmartStream

According to the CCP Research Foundation, which tracks FI fines, firms have paid out a total of £173bn (2008-2013) in fines across all FS segments since the crash, which is in and of itself another driver for change.

"The record fines levied against FIs certainly come to mind as an additional driver for the adoption of utilities, which also offer better data quality," says Tom Dalglish, Head of Transformation at SmartStream. "It's now viewed as a disadvantage and too risky to undertake such compliance activities without the agreed counterparty and quality enforcement attributes of a financial utility."

Defining a utility

SmartStream claims to be the first to launch a reference data utility four years ago. According to Dalglish it now offers shared processing services across cash management, corporate actions, reconciliation and other such activities. For instance, it handles all the reconciliation for Santander bank UK across their operations, although if that makes it a utility or a service is a moot point.

Similarly, Credit Agricole Corporate and Investment Bank (CA CIB) has partnered with FIS to offer global banking firms a platform to share their IT services for cross-asset derivatives – reducing the unit cost of execution and increasing efficiency. It could be argued this isn't a post-trade utility solution at all, rather a shared service platform. If it were ever to get enough users, however, does it suddenly become a utility?


Virginie O'Shea
Aite Group

Conversely, huge projects such as the move towards T+2 settlement this year and the Eurosystem TARGET2-Securities (T2S) single settlement engine on the financial markets are truly sector-wide enhancements, but they are driven by regulation and are not seen as a utility – despite their usefulness.

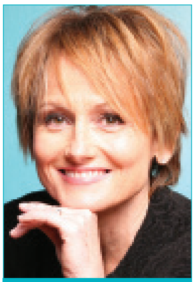
The element of compulsion means the move towards them is not voluntary and hence they are not seen as a true utility. This requires firms to collaborate willingly to achieve a common goal, share their compliance or operational burden and cost, and work together to achieve a unified solution. Establishing a utility should be more than a compliance tick. A true utility requires active, rather than grudging, cooperation for the shared benefit of everyone in the chain, not just retail investors, regulators or other beneficial end users.

Defining what is and what isn't a utility is never easy. Lots of vendors are claiming to be 'utilities' but really they are just re-branding existing shared services. It's only a true utility if it's a collaborative effort in a non-compete arena – like CLS – and ideally a single offering.

In Europe there have been six trade repositories (TRs) launched under EMIR to centrally store derivative trades in case of future crashes – are they a financial utility? "While no-one calls them a utility – as there is no single entity – they are utility-like in that there is no competitive benefit to them; they're a regulatory tick," says Virginie O'Shea, Senior Analyst at Aite Group, covering data management and post-trade technology.

"You might end up with similar numbers of multiple utilities in other areas, like KYC for instance, all serving a common need but with no single platform (at least until some consolidate or exit in later years)."

There are a lot of ambitious launches in the KYC space but some full service offerings might be over ambitious in the scope of their offering. Would all FIs want a third party dealing directly with their clients for the whole lifecycle? "No, because it's a disintermediation threat to their front office client contact where they hope to get some money out of the relationship," says O'Shea. "By all means outsource back end processing in non-competitive areas. But beyond that it has to be debatable if enough larger clients would migrate en masse to some services in sufficient volume to make them a utility – as opposed to a back end document management system."


Anna Mazzone
Thomson Reuters

Utility operators: KYC

Anna Mazzone, Thomson Reuters' Global Head of KYC is in charge of its Accelus Org ID KYC platform, which was one of the early KYC utility launches, going live in March 2014. According to her the service already has four clients comprising of an unnamed tier 1 global bank, the MAN Group asset managers; and FXall and Tradeweb (both of which are owned by Thomson Reuters).

"The service is essentially a KYC registration profile service for counterparties," says Mazzone. "We were first to market and currently process 12,000 records. That will grow with the tier 1 bank that we're adding now and, hopefully, from the addition of several other firms – hedge funds, corporate treasurers, brokers & others – that we're currently in discussions with. We cover 60 countries and 30 languages."

A true utility requires active, rather than grudging, cooperation for the shared benefit of everyone in the chain, not just retail investors, regulators or other beneficial end users

In terms of the build out process Mazzone maintains that it's not easy. "You need to collect all the legal documents, find out who is the beneficial owner and do the on-boarding, prior to doing the actual processing. Then you have to update any changes as part of the on-going management function, and ensure resiliency against cyber-attacks and downtime," she says.

De-risking is another important driver as by joining a utility you are effectively sharing the regulatory risk exposure and agreeing on a minimum data quality required to alleviate that risk. "I've had conversations with heads of legal counsel at global tier one banks," says Mazzone, "and they tell me that by defining the quality of the counterparty profile you automatically de-risk your operations. You can identify politically exposed persons (PEPs) more easily or adhere to whatever regulation is necessary."


Yasmeen Jaffer
Markit

According to Yasmeen Jaffer, Global Head of Business Development for KYC services at Markit, which partners with Genpact (an Indian-based outsourcing and processing firm), migration to a central service requires a shift in mindset for the industry.

"Operations have traditionally been viewed as something that would stay in-house, but firms now realise they need to organise themselves differently," she says. "The conversations we have with clients focus on how we can lift the operational burden of managing KYC data and enable them to shift resources towards areas which give them competitive advantages ... think of the credit card industry where Visa and MasterCard created centralised services for card issuers. KYC is now undergoing a similar transformation."

Markit and Genpact offer a standard for KYC data collection and management that was developed with design partners, Citi, Deutsche Bank, HSBC and Morgan Stanley.

The sheer number of KYC offerings means that not all of them will survive in future years and there will likely be a consolidation – ditto in the post-trade, collateral management, payment and other FS segments currently seeing the rise of utilities.

Drivers for the rise of financial utilities

- Regulation
- Rising cost of capital / operation
- Better data quality, operational control & De-risking.

Post-trade and Collateral Utilities

All sectors of the FS industry are seeing utilities. For instance, there are numerous post-trade services and reference data services, such as the DTCC Clarient Global entity hub, which is seeking to standardise, centralise and automate the collection and validation of client data and documentation for the sell and buy-side. This might include client data and reporting requirements necessary under EMIR/Dodd Frank.

"Clarient is an industry owned and governed utility, developed by DTCC in close collaboration with founder banks Barclays, BNYMellon, Credit Suisse, Goldman Sachs, JPMorgan Chase and State Street, plus more than 10 of the world's top asset managers and hedge funds," says CEO Matt Stauffer. "The integrated platform brings together Omgeo's SSI Alert, the Counterparty Reference Data and Enrichment Service; data from Avox's Managed Data Service; LEI data, along with the data and documentation collected by Clarient to create a central view of a legal entity; all allied with DTCC client reference data services."


Matt Stauffer
Clariant

It is one of many platforms launching this year and battling for volume and users to improve economies-of-scale performance.

Finally, there is the field of collateral management, which is also in the process of developing financial utilities under the impact of the Basel III capital adequacy regime and other changing regs. The liquidity coverage ratio (LCR) and Net Stable Funding Ratio (NSFR) stipulations will change the way banks, traders, financial market infrastructures (FMIs) and market participants lend and operate. Some bank clients will be rewarded for providing intraday liquidity when it is needed, others may be penalised for giving a bank too much unplanned liquidity – and too much of a matching collateral requirement. Banks will rely on the FMIs, and so on.

"Getting the right collateral to the right place, at the right time,

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has become imperative for capital markets," explains Olivier de Schaetzen, Global Head of Product Solutions at Euroclear SA/NV, and the man responsible for tri-party collateral management services.

Basel III, KYC, Dodd-Frank, EMIR, and the numerous other post-crash regulations and market procedure changes cumulatively mean that the reference data, settlement, collateral requirement and market practices on global financial markets are all changing.

Custodian banks, central securities depositories (CSDs) and others in the chain all have to change their mode of operation, with many grouping together in order to do this. Meeting the increased need for more complex margin calls, OTC clearing and risk mitigation, more reporting, clarity and so forth is not easy: utilities can help.

There is a need for collateral management services in such an environment, as opposed to collateral optimisation solutions which will remain proprietary and competitive. It is early days yet in this developing market but one early market offering is the Euroclear-DTCC Global Collateral joint venture announced last Autumn at SWIFT's Sibos 2014 trade show. The global collateral processing utility is a UK-based jv with open architecture services designed to allow access for other CSDs, custodians and settlement agents; which may join later on if the utility ever gets off the ground. It is yet to do so.

> *Meeting the increased need for more complex margin calls, OTC clearing and risk mitigation, more reporting, clarity and so forth is not easy: utilities can help*

Olivier de Schaetzen
Euroclear SA/NV

Consolidation: who will survive?

With so many financial utilities due to launch or already live across different FS sectors, it is certain that there will be consolidation. "In three years' time, we'll have a clearer view of those that have been successful," says Julien Limacher, Partner at the Capco consultancy.

Julien Limacher
Capco

If one of the best definitions of a utility is that it is a single entity providing economies-of scale efficiency, then not all of the new launches can last. Lots will remain because they meet the other definition of being useful, beneficial or profit-able – for vendors or banking collectives – but by no means can all survive.

"Scale will be critical to managing cost over time. First mover advantage could be crucial," says RBS' Rolfe. He added that further operational consolidation is likely as specialists join up to provide wider coverage by region or product.

According to Thomson Reuters' Mazzone: "The adoption of common standards, messaging and practices – plus managerial oversight to compliment technological integration and effective resiliency – will also be a key driver in determining what utilities survive."

As Capco's Limacher concludes, "utilities are a mature concept in other industries." Why not in the FS sector?

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