NRI

lakyara vol.233

Utility services for investment banks

Naoya Hiranaka

24.February.2016

Nomura Research Institute, Ltd.

Executive Summary

Naoya Hiranaka
Senior Consultant
GWS IT Solution Department I

Utilization of utility services is emerging as a global trend among investment banks. Investment banks must use utility services more effectively to not only reduce costs but also provide higher-quality services more efficiently.

Global trend toward utility services

Cost-cutting is a key management priority for investment banks amid an ongoing decline in fee revenues. To reduce costs, many global investment banks have outsourced post-trade processes regarded as cost centers. Such outsourcing has generally taken the form of labor-cost arbitrage (depicted in the accompanying diagram's upper portion within the dotted box), with financial institutions relocating operations from their home countries to another country with lower labor costs such as India, Singapore or China.

However, labor cost arbitrage has a number of drawbacks, including the following.

- After exchange rate variability is factored in, offshoring may not necessarily yield much if any labor cost savings in home-currency terms.
- In countries without a culture of long-term employment, outsourcing service providers have high employee turnover and unstable workforces, resulting in perpetual employee training costs.
- Even when outsourced to a region with low labor costs, operations must be conducted in compliance with the regulations, infrastructural specifications and market customs of the countries in which the services are provided. IT infrastructure consequently must be customized to meet such compliance requirements.

In response to such drawbacks, investment banks are switching to outsourcing models other than labor cost arbitrage. One such model is utility services.

With utility services, outsourced operations are repatriated from an offshore location to the home country in which trade settlement is actually executed. From the standpoint of connectivity with settlement institutions and timely access to information about regulatory/structural changes, conducting post-trade processes in the home country is optimal in terms of flexibly complying with the country's local rules. However, outsourcing must deliver cost savings even when the outsourced operations are brought back to the home country. To realize cost savings, investment banks are outsourcing business processes to utility vendors that perform the processes in the home country (left panel of diagram).

Utility services typically standardize business processes that need not be differentiated from other companies'. They do so by adapting such processes to conform to a target operating model. They then automate the process with IT to the extent possible. In other words, utility service providers combine business process outsourcing (BPO) and IT outsourcing (ITO) to provide standardized services to multiple financial institutions. A wide variety of vendors are entering the utility service market globally[1)].

NOTE

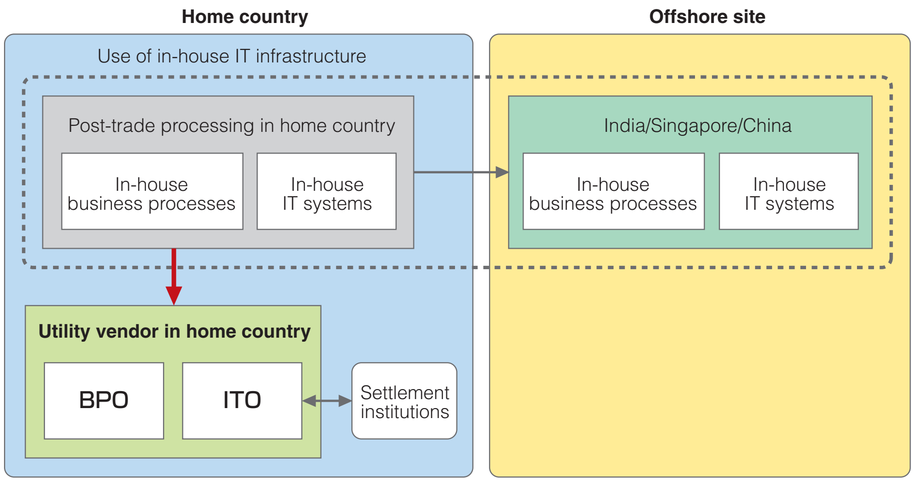
1) Globally, a number of vendors are already offering utility services. Accenture is doing so under the APTP (Accenture Post Trade Processing) brand name. Additionally, SunGard has launched a utility service in the listed/OTC derivative space with Barclays as its anchor client.

Utility services' benefits

In capital market businesses, investment banks must deal with many exceptions in the course of their regular business flow, from account origination to order submission, post-trade settlement and client reporting. Meanwhile, certain business processes, such as those related to ETF creation and equity IPOs, involve a wide variety of tasks.

Additionally, financial institutions must expeditiously comply with frequent regulatory and infrastructural changes, examples of which include the global trend toward shorter settlement cycles (e.g., migration to T+1 settlement of government bond trades and T+2 settlement of equity trades in Japan) and changes in various reports to regulatory authorities. Whenever such a change occurs, investment banks must research and analyze its impact on their operations and determine whether they need to redesign

Migration from labor cost arbitrage to local utility service



Source: NRI

or otherwise modify their business processes. The most impactful changes are ones that require modification of the IT infrastructure that supports the affected business processes.

In the case of business processes outsourced to offshore providers, the tasks involved with complying with regulatory or infrastructural changes must be performed in the home country. However, if an investment bank utilizes a utility service that combines BPO and ITO, it can outsource any task from business-process redesign to IT infrastructure upgrades to its utility vendor, thus freeing itself from the burden of complying with regulatory/infrastructural changes. Additionally, use of utility services leads to reductions in personnel expenses, administrative costs and rent. Other potential ancillary benefits include conversion of fixed costs to variable costs, liberation from dependence on employees with specific skills, obviation of the need to redeploy resources in conjunction with business process modifications and, in turn, more efficient risk management.

Additional considerations for utility service users

The benefits of using a utility service are generally modest when the service is used for only one of a serial business process's tasks (e.g., trade matching). For example, in the case of equity-related post-trade processing, investment banks should utilize utility services for every process step from clearing/settlement to reporting to maximize the utility services' benefits. Investment banks reap maximal efficiency benefits by using the services of vendors that provide services encompassing all of a business process's constituent tasks. Other key considerations in terms of selection of a utility vendor include not only whether the vendor is well-versed in local market practices and capable of flexibly adapting to regulatory/infrastructural changes but also whether the provider offers state-of-the-art information security, has a robust business continuity plan and conducts governance based on service level agreements (SLA)[2]. Another key consideration is whether the vendor has IT infrastructure robust enough to efficiently and stably support BPO.

2) SLAs are agreements between service providers and their customers regarding the level of service to be provided (definitions, scope, service specifications, targets, etc.). They specify the extent of the service provider's quality assurance to the customer.

Utilization of utility services is becoming a global trend in capital markets. Large profitability gaps may emerge between investment banks that do not utilize utility services and investment banks that do utilize them and are therefore better able to invest in strategic priorities (e.g., new product development) by virtue of the resultant cost savings and efficiency gains. Utilization of utility services will likely become a hot topic among investment banks even in Japan.

about NRI

Nomura Research Institute, Ltd. ("NRI", TYO: 4307) is an independent, global IT solutions and consulting services provider with annual sales of 406.0 billion yen as of FY ended March 2015. With front-to-back support for the buy- and sell-side, NRI's tradition of innovation has positioned them as a trusted international market leader. Leveraging NRI's global consulting business, NRI is able to provide innovative financial IT solutions for investment banks, asset managers, banks and insurance providers. For more information, visit www.nri.com.

Inquiries to : Financial IT Marketing Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.com/global/opinion/lakyara/index