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Regulatory inflection point raises the bar for market infrastructures

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A perfect storm of challenges, sparked by the fallout of the 2008 global financial crisis and the implementation of new global regulations, is reshaping the landscape of financial services and opening the door for clearinghouses, central securities depositories and other market infrastructures to play a more prominent role in helping firms drive down costs and reduce risks.

Today, the industry stands at a crossroads – or inflection point – that requires financial institutions to fundamentally change how they operate and rethink how to grow profits and ensure greater market stability. New regulatory mandates are driving up the cost and complexity of doing business and creating one of the most challenging return-on-equity (ROE) environments in decades.

Prior to the crisis, the industry had a great deal of excess capacity, capital was cheap, and firms had sufficient revenue-generating operations. In some cases, however, this capacity and capital were misapplied as firms created and funded multiple consortiums in an attempt to gain efficiencies and economies of scale, particularly as it related to the back office processing of financial transactions and data. In the syndicated loan market, for example, efforts by a group of banks several years ago to create a new trading and servicing platform and interconnect it to all the disparate loan data management systems sounded like a win-win. 5-plus years later, however, it has not yet fulfilled its value proposition to the industry.

Today, much of that excess capacity has been wrung out of the business – from outsourcing and layoffs to major divestments and restructurings. Despite this, firms continue to struggle to grow due, in large part, to the ongoing economic slump and the onset of new regulations. For instance, new capital requirements for swaps transactions have the potential to create a massive liquidity squeeze while other provisions, such as the Volcker Rule, have already prompted some firms to close or spin-off entire divisions.

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In this environment, especially when capital remains scarce and organic growth is difficult to achieve, firms are no longer in a position to make multiple bets like they did in the past with the hope that one or two will pay off.

At this inflection point, the industry needs to fully leverage market infrastructures to reap the benefits of scale and standardization in order to reduce costs, gain efficiencies, and mitigate risk. The infrastructure underpins the global financial system and plays a critical role in providing the stability, certainty, and reliability needed for markets to operate efficiently.

Over the past several decades, market infrastructure organizations have also helped spur market growth by utilizing a wide range of back office functions, such as clearance and settlement or the processing of corporate actions announcements, to wring the costs out of performing these operations. Today, the opportunity exists for the infrastructure to move further up the processing chain to mutualize middle- and front-office processes that do not generate revenue or provide firms with a competitive advantage.

There is no business sense in financial institutions separately bearing the costs and risks to perform non-value added functions like post-trade allocation or setting up client data when they can be outsourced to market infrastructures, which can leverage economies of scale to drive down costs and mitigate risk. The potential cost-savings could be significant when one considers that the total spent by the industry to support the global post-trade infrastructure is estimated at $100 billion or more annually.

To realize these opportunities, however, financial leaders need to think creatively and be just as inventive and bold as the visionaries in the 1970s, who recognized the need for change and put the U.S. on the path to establishing a central securities depository and implementing central clearing. These transformative decisions helped modernize the US capital markets and sparked an unprecedented period of growth that allowed them to develop into the deepest, most robust, liquid, and efficient in the world.

Despite the many challenges of the current economic and regulatory environments, exciting opportunities exist for the industry to leverage market infrastructures in the years ahead. For example, with margin calls and collateral settlement activity expected to increase by a factor of 5-10 due to regulatory changes and mandated clearing of OTC derivatives trades, a collateral management utility that streamlines collateral settlement could significantly reduce systemic risks and processing costs. These types of ideas reflect the level of innovation that is needed today to help the financial industry regain its footing and re-establish the strength and vitality of global financial markets.

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