Financial Services

SECURITIES SERVICES: THE GOOD TIMES ARE OVER, IT IS TIME TO ACT

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SUMMARY

ARE THE GOOD OLD DAYS OVER?

The securities services industry enjoyed healthy growth in the decade prior to the financial crisis. The volume of financial assets requiring custody was increasing and so was investors' use of third party administration. Since the financial crisis, however, the industry has been struggling with depressed asset values, low interest rates, and plunging profits in the formally lucrative securities lending and foreign exchange businesses.

Many observers and industry insiders initially viewed these challenges as a "cyclical blip". The experience of the last several years, however, is leading many to fear that this state of affairs is "secular". With the exception of asset values, no profit drivers are back to its pre-crisis level. At the same time, burdensome new regulations are being applied to the industry with a view to reducing systemic risk and protecting customers.

These regulatory and economic pressures are changing the competitive landscape in the post-trade value chain. Traditional securities services players – global custodians, local custodians and fund services specialists – face new and growing competition from Central Securities Depositories (CSD), Central Counterparty Clearing Houses (CCP) and outsourced services providers.

Meanwhile, client needs continue to evolve. Increasingly complex securities and investment strategies are creating demand for more bespoke solutions which, in turn, requires investment in technology and product development.

Asset values have recovered globally and industry revenues are expected to grow over the next few years. However, few large players have maintained their margins. Sustaining growth with healthier margins will be challenging in the current economic and competitive environments. Providers will need to pursue a portfolio of strategic initiatives, combining actions that optimize their core business with strategies aimed at capturing areas of growth and calculated bets that can reshape their business models.

In this report, we describe the state of the industry and explore five strategic hypotheses that could help providers address the current challenges. These hypotheses are not meant to be comprehensive or mutually exclusive. We do not intend to prescribe answers but only to suggest some ways out of the situation in which many players find themselves. The right answer for any given firm will depend on its starting point, risk appetite, investment capacity, and execution capabilities.

DEFINITION OF SECURITIES SERVICES

The securities services ecosystem consists of a wide range of services that are offered to clients that issue, trade, and hold securities.

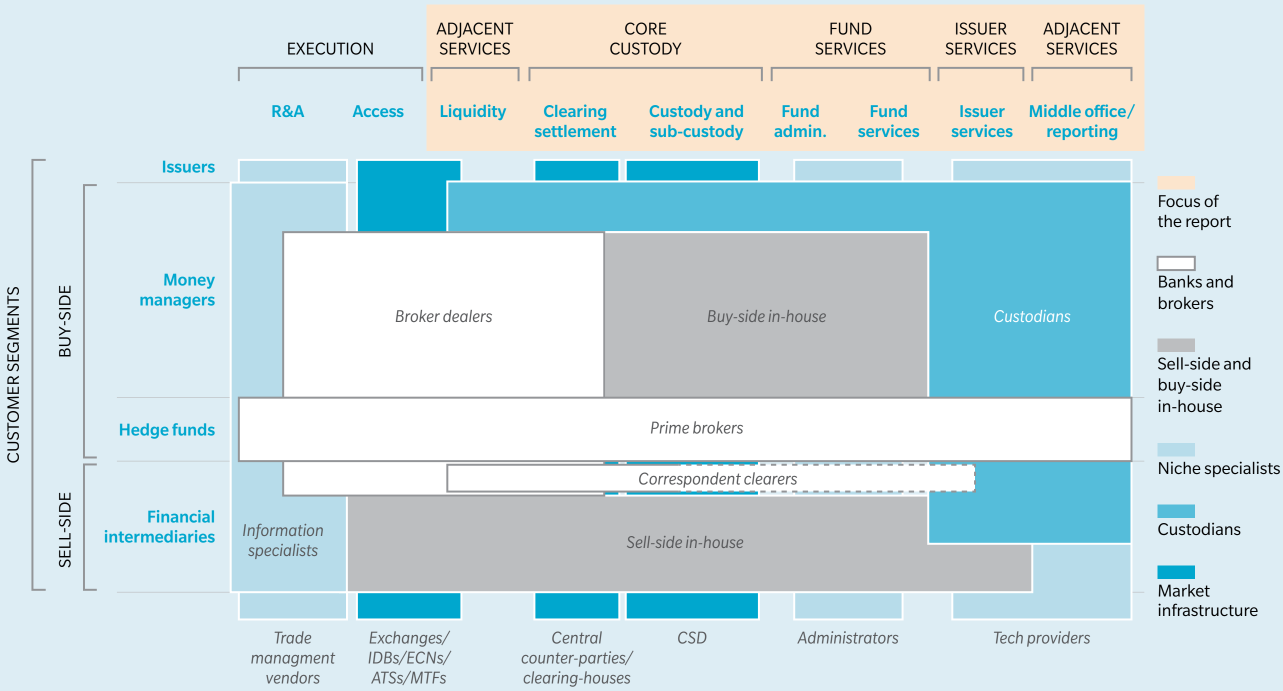
For the purpose of this report, we define the securities servicing market as follows (see Exhibit 1):

- Services: Custody/Settlement, Fund Services, Issuer Services, Adjacent Services (Liquidity Management, Middle Office and Reporting)
- Clients: Asset Managers (Traditional and Alternatives), Asset Owners (Pensions, Insurers, Sovereign Wealth Fund (SWF), Charities), Financial Institutions and Banks – "FIB" (Retail and Commercial Banks, Broker-Dealers, Private Banks), Corporates
- Providers: Core providers (global custodians, local/sub custodians, fund services specialists) and adjacent players (CSDs, international CSDs, CCPs, prime brokers, technology providers and outsourced services providers)

Exhibit 1A: Securities services product overview

CORE CUSTODY		FUND SERVICES		ISSUER SERVICES	ADJACENT SERVICES	
Clearing and settlement	**Custody and sub-custody**	**Fund administration**	**Fund processing and distribution**	**Issuer services**	**Middle-office and reporting**	**Liquidity management**
• Listed and OTC clearing • Bilateral and central clearing • Cross-border settlement • Domestic settlement in CSDs	• Global custody • Local/sub-custody • Safekeeping • Corporate actions • Income processing • Tax reclaim • Proxy voting • Trustee	• Fund accounting and administration – NAV calculation – Pricing – Reporting • Compliance reporting – Solvency II	• Transfer agent • Subscription and redemption • Fund distribution	• Issuer and shareholders services • Escrow and agency services • Depository receipts	• Portfolio administration • Trade support • Reconciliations • KYC, account set-up • Reference data • Collateral administration • Risk analytics • Performance attribution • Pricing	• Securities lending and borrowing • Collateral optimization and transformation • Custody related execution (Forex) • Cash management/ treasury

Exhibit 1B: Securities services eco-system

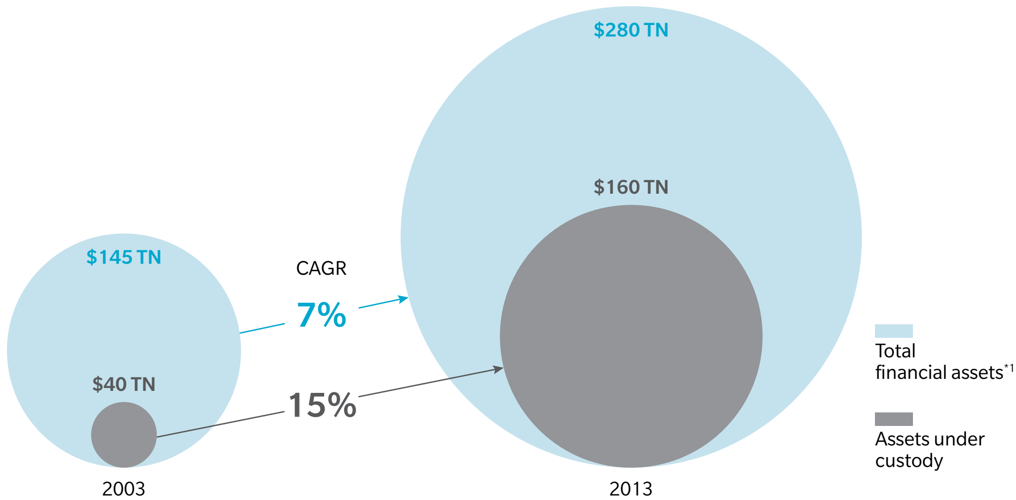


Source: Oliver Wyman

MARKET CONTEXT: "GOOD OLD DAYS ARE GONE"

Before the onset of the recent financial crisis, the securities servicing industry enjoyed a multi-decade period of largely uninterrupted growth, driven by a number of "mega trends", including strong growth of financial assets, cross-border and multi-asset class investing, the rise of alternatives, and the trend for asset managers to increasingly outsource non-core back-office functions.

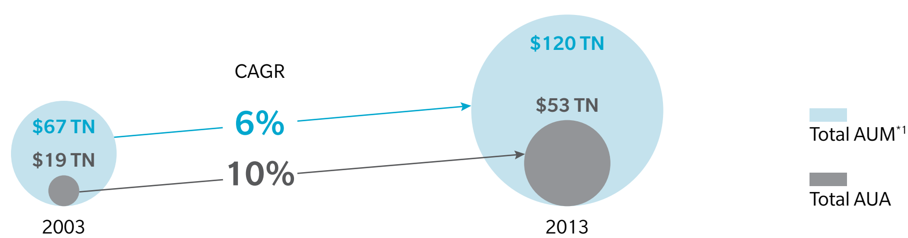
Exhibit 2: Total financial assets and assets under custody (AUC)



Source: Bank for International Settlements, The World Federation of Exchanges Limited, http://www.globalcustody.net, Oliver Wyman analysis

*1. Includes equity, bonds, securitized loans and listed derivatives

Exhibit 3: Total assets under management (AUM) and assets under administration (AUA)



Source: The City UK, Preqin, Investment Company Institute, Towers Watson, Sovereign Wealth Fund Institute, http://www.globalcustody.net, Oliver Wyman analysis

*1. Professionally managed and internally managed insurance, pension, SWF and endowment assets

However, since the crisis in 2008, the traditional securities services industry model and economics have come under pressure due to headwinds on key drivers of growth and profitability in the industry. For many securities services providers, the question is whether "the good old days are over."

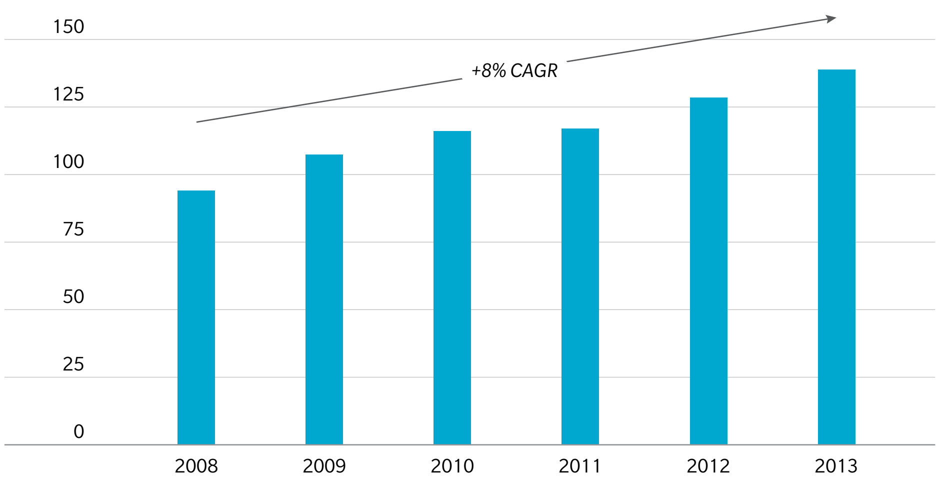
A SECULAR CHANGE IN INDUSTRY ECONOMICS?

After a significant drop in revenues in 2009, the industry benefited from a rebound in top line revenue to reach a total revenue pool of ~US $45 BN in 2014[1]. This growth was mostly driven by stabilization of revenues in North America and Europe, significant growth in emerging markets and, above all, the increase in both assets under custody (AUC) and assets under administration (AUA).

While this picture seems positive, our analysis suggests the growth in top line is driven largely by asset value appreciation and other drivers of revenue growth and profitability have not recovered to their pre-crisis levels.

Specifically, the AUC+AUA growth for the top 10 providers (which make up the bulk of the market) has been around 8% p.a. since 2008 (see Exhibit 4). We estimate an investment portfolio of equity and bonds typically held by custodians has grown at exactly that level in the same period[2].

Exhibit 4: Top 10 custodians AUC+AUA (in US $TN)



Source: Annual reports, Oliver Wyman analysis

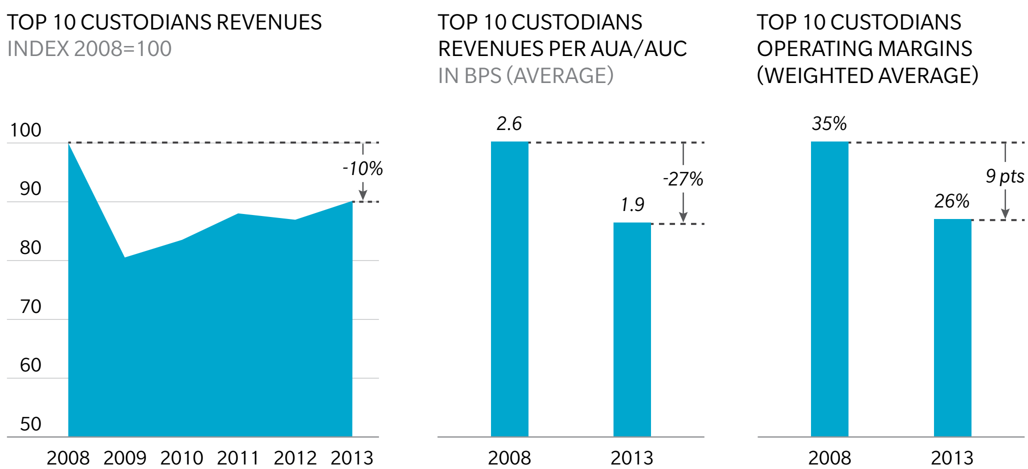
1 This revenue pool estimate is associated with products summarized in Exhibit 1A and generated by global and local custodians and fund specialists.

2 Portfolio composition assumed to be 60% equity and 40% bonds. Growth figures based on "MSCI All Countries World Index" and "Barclays Aggregate Bond Fund Index."

In fact, global revenue pools are still below pre-crisis level and revenues per AUA/AUC have also dropped significantly. Again, an analysis of the top 10 players shows that total revenue for this group is still 8% below 2008 levels and revenues per AUA/AUC is nearly 30% lower compared to 2008.

Over the same period of time, the operating margin has significantly decreased from 35% to 26% (weighted average of top 10 players), driven by both an overall revenue decline and a cost increase.

Exhibit 5: Top 10 economics evolution



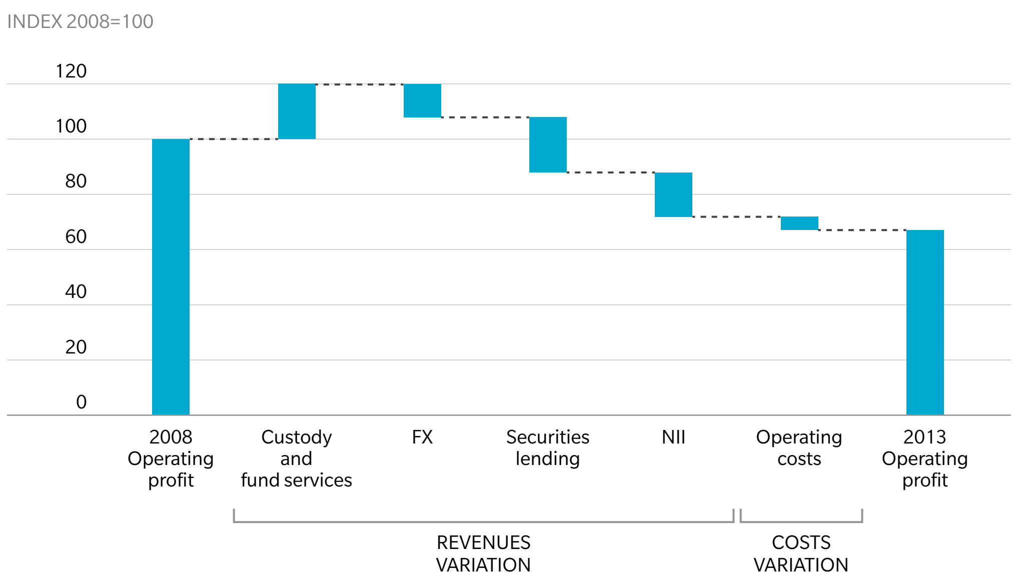
Source: Annual reports, Oliver Wyman analysis

Notwithstanding the strong asset value recovery (8% p.a.), the custody and fund services revenues grew only at a limited 2% p.a due to fee compression. Other sources of revenues declined significantly since 2008 and more than offset the modest growth in services revenues.

- The drop in volumes as well as spreads led to a significant drop of securities lending revenues (around 20% p.a.)
- The sharp decline in interest rates has also contributed to lower revenues but the impact was limited thanks to increase in the volume of deposits. Net interest income decreased by roughly 5% p.a.
- Finally, lower FX spreads and volumes led to an overall drop in revenues (~10% p.a.)

Meanwhile, operating costs have continued to rise (at ~1% p.a.), leading to significant margin deterioration (see Exhibit 6). The failure of the industry as a whole to lower costs commensurate with the drop in revenues was driven by both exogenous factors and self-inflicted failure to react sufficiently quickly and substantively in many cases. Much of the additional growth and new deals came in offerings that required high levels of customization and low levels of straight-through-processing and automation. The need to comply with regulatory requirements such as T2S or develop new offerings driven by regulation (e.g. AIFMD) also drove investment requirements at a time where the return for those investments were, at best, uncertain and likely not meaningful, in the near term.

Exhibit 6: Top 10 custodians operating profit evolution (2008-2013)



Source: Annual reports, Oliver Wyman analysis

A CHANGING COMPETITIVE LANDSCAPE?

These economic pressures and some of the post-trade regulatory changes have also resulted in a process of gradual repositioning amongst the players providing services along the trading value chain.

Global and regional custodians have been consolidating the market over the last years to acquire new clients and drive economies of scale in order to compete on price for the traditional services (custody and fund administration). We expect the market to stay consolidated and, perhaps, even consolidate further organically given the scale and scope advantages the top players are likely to enjoy for most products and segments. In order to capture growth, some players are extending the type of services they offer, like derivatives clearing and collateral services, or middle office services not just for asset managers (which most leading providers are now offering) but also for banks/brokers (e.g. Societe Generale Securities Services Middle and Back Office Outsourcing Solution for broker/dealers). Most of these initiatives are relatively new and will require time to get significant market traction.

Local custodians operating in a specific market will be facing increased pressure from global and pan-regional custodians who are trying to increase their direct presence in local markets giving them greater control over the management of liquidity and greater flexibility around the services provided to their clients. These players are either merging/being acquired by larger/regional providers (e.g. BNPP's recent acquisition of Commerzbank's "depotbank" business in Germany) or are undertaking broad strategic reviews of their businesses to reposition themselves in various ways.

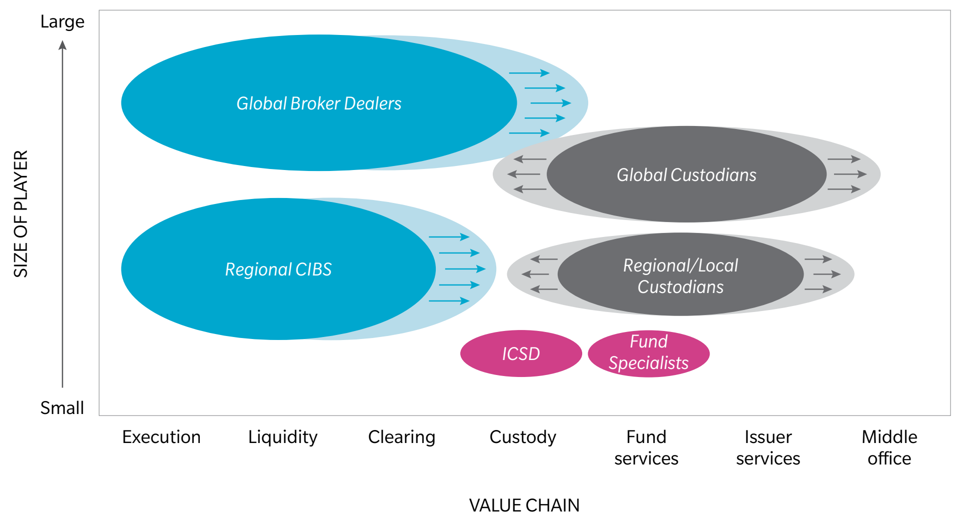
Global broker/dealers have focused on ways to capture the value migration that is shifting from execution to post trade activities mainly driven by OTC reform. Many are developing or offering clearing/settlement/collateral management services, and when they have a securities servicing business, they combine it with select capital markets activities to form a more holistic "end to end" offering (e.g. JPM, SG, BNPP). Whether this represents a threat for the monolines focused on their core of global custody and fund services remains to be seen (See hypothesis number 2 in next section).

Competition from ICSDs is also intensifying as they are developing banking services as part of a revenue/growth diversification strategy. Some are becoming particularly active in collateral services (e.g. Euroclear's Collateral Highway), cross border settlement (e.g. T2S connectivity offering) and outsourcing services (e.g. DTCC client reference data solution called Clarient).

Fund services specialists are increasing the competition intensity as well by investing significantly in new and focused offerings (e.g. SSC GlobeOp targeted offering for alternative asset managers including IT solutions and outsourcing services) and by consolidating the market (especially in alternative fund administration).

The competition from outsourcers and technology vendors has also intensified as they develop business process outsourcing (BPO) and information technology outsourcing (ITO) services directly competing with middle and back office (MO/BO) services proposed to asset managers and banks/brokers (e.g. Markit-Genpact offering for KYC services, Accenture/Broadridge Back-Office outsourcing solution for broker/dealers).

Exhibit 7: Competitive dynamics



Source: Oliver Wyman analysis

CLIENTS ARE BECOMING EVEN MORE DEMANDING

Meanwhile, client needs have also been evolving as a result of increased complexity, new asset classes, changing/new regulation (e.g. AIFMD), and increased appetite for outsourcing bigger portions of their middle and back office operations.

While, overall, those are favorable developments for providers, it also raises the ante in terms of breadth of product offerings, bespoke solutions, and continued pressure on investment requirements at a time when those resources are in short supply and unlikely to generate immediate returns.

In addition, the increased need for customized offerings, whether it is private equity funds services, regulatory reporting for insurers, or AIFMD offering for alternative managers, will create opportunities for well-positioned niche providers, in some cases potentially negating the scale and scope advantages large players enjoy.

Buy-side and sell-side institutions, under increasing cost pressure, will continue to seek out ways to centralize and outsource key Ops and IT functions to strip out redundant costs. Global custodians will need to figure out a way to compete for this opportunity as market infrastructure players and outsourcers/fin tech players increasingly focus on this space.

KEY REGULATIONS AND IMPLICATIONS

New regulations are reshaping the trade and post-trade industry affecting both securities services players and their customers. T2S, Leverage Ratio, and FATCA regulations apply directly to securities services providers. The rest largely apply to investors, and can create new business opportunities for providers. The industry is still in process of complying with these regulations and understanding their business implications.

Exhibit 8

	REGULATION	IMPACTS ON CLIENTS	IMPLICATIONS FOR SECURITIES SERVICES PROVIDERS
Interoperability	T2S	• Reduction of settlement costs in Eurozone • Simplification of settlement processes in Europe • Opportunity to delayer exposures and pool collateral	• High impact on sub custodians with settlement revenue loss, and potential increased CSD competition in asset servicing • Opportunity for global/regional custodian to leverage T2S capacity for a pan-European asset servicing offering. EU global custodians expected to connect T2S directly
	UCITS V	• In Europe, increased internationalization of fund distribution • Reduced number of global custodian relationships	• Adaptation of international distribution capabilities as a result of fund passports
	CSDR/T+2	• Obligation for market participants and CSD to settle trades in 2 days maximum in Eurozone • Reduced processing costs due to faster reconciliation/settlement	• Upgrades required on settlement systems to comply with requirement
Financial stability and control	Solvency 2	• Introduction of risk-based solvency and capital requirements and new risk governance and risk management reporting for insurers	• Increased needs from insurers for detailed reporting (risk, valuation, granularity) and potentially outsourcing this activity • Increased needs for yield enhancement solutions (e.g. securities lending)
	CRD 4/B3	• Higher capital requirements and stricter leverage limits affecting particularly wholesale banks • Liquidity Coverage Ratio (LCR) making some wholesale deposits less	• Opportunity to develop MO/BO outsourcing offering for sell side looking for cost efficiency sources • Need to develop a much more granular liquidity management and deposit pricing strategy
	OTC derivatives (DFA/EMIR)	• Connectivity to electronic venues and development of transactional reporting • Needs for clearing and collateral management solutions	• New revenue streams in electronic execution, central clearing and collateral management • Custodians are lining up to provide collateral and clearing services but strong competition expected from broker-dealers
	MIFID 2	• Introduces measures to improve transparency and regulation/controls of more opaque markets (e.g. derivatives)	• Creates needs for additional reporting capabilities to latest standard
	Alternatives transparency (AIFMD, DFA)	• Tighter regulation of alternative/hedge funds (Non-UCITS) – Single depository with increased liability • Requires hedge funds to register with national regulators and greater transparency/disclosures	• Increased need from hedge funds on reporting services, (e.g. independent valuations, credit exposure) • Creates an opportunity to price up services to hedge funds or, at a minimum, serves as protection/floor against any downward pressure on other services
Investor/ asset protection	FATCA	• Regulation impacting US clients to report foreign financial account ownership	• Impacts all domestic/foreign financial institutions that make and/or receive withholdable payments • Technical challenges, e.g. requires systems to withhold tax on payments to people/entities not in good standing in the regime
	MIFID 2	• Introduces measures to improve investor protection (best execution)	• Increased reporting burden for custodians • Upgrades required in governance and record keeping
	UCITS V	• Increased protection for fund administration customers	• While rules are not yet finalized, increased fiduciary responsibility/liability is to be shifted onto custodians

Source: Oliver Wyman analysis

GROWTH IN EMERGING MARKETS IS UNLIKELY TO BE A PANACEA

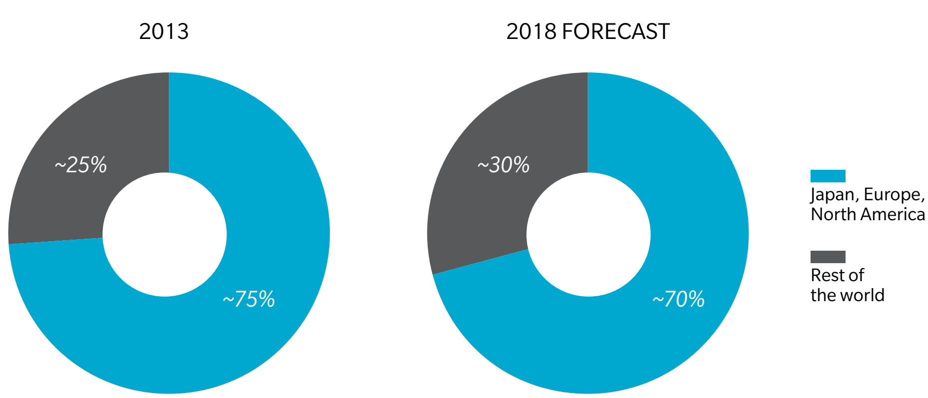
In this challenging context, most players are tempted to look for new territories and markets with better growth potential and improved economics. For instance, BNY Mellon started a custody business in Brazil in 2012 and now plans to grow its activity by 60% by the end of 2015. Likewise, Citi acquired, in 2013, ING's custody and securities services business in seven Central and Eastern European ("CEE") markets currently representing €110 BN in assets under custody.

Indeed, we expect emerging markets to enjoy close to double digit growth in terms of securities services revenue pools, driven by deepening financial markets, growth in financial asset pools, and increased servicing needs on the part of investors. As an illustration, AUC in China increased by 56% in 2013[3].

In addition to higher growth, pricing and margins in large parts of emerging markets (EM) tend to be significantly healthier than those in North America or Europe, particularly for players that have a direct custody network in those markets (e.g. Citi, HSBC).

With all that said, we expect that the bulk of assets and associated revenue pools will remain in mature markets (Japan, Europe and North America) as shown on Exhibit 9. As a consequence, while EM will represent a source of growth and diversification for well-positioned global and some local players, we do not expect that to represent a "game changer" for most players in the industry, at least not in the near to medium term, particularly for global custodians.

Exhibit 9: Securities services revenue pool breakdown



Source: Oliver Wyman analysis

3 Source: China Banking Association.

In short, the market is under some structural changes, driven by a combination of cyclical and secular economic factors (e.g. rates, securities lending), a multifaceted and complex regulatory environment affecting both client demand and provider economics in different ways, and an evolving competitive landscape with non-custodians (e.g. ICSDs) attempting to capture part of the overall securities services pie through offerings like collateral optimization.

Against this backdrop, let us now turn to potential strategic responses providers can consider.

STRATEGIC HYPOTHESES AND KEY QUESTIONS FOR PROVIDERS

In this section, we have laid out five strategic hypotheses for the industry to illustrate the types of potential avenues and initiatives that providers can consider:

Hypothesis 1. From profitable business to commoditized business to market utility?

Hypothesis 2. Diversified players will have a competitive advantage?

Hypothesis 3. Opportunities outside of the core market?

Hypothesis 4. Scale is overrated, specialization is in?

Hypothesis 5. Technology and data to the rescue?

Please note that these hypotheses are not meant to be comprehensive, exhaustive or mutually exclusive; and not all will be relevant for all situations or all players. Our objective is not to prescribe any specific answers but rather lay out some ideas and perspectives that may be of interest to providers as they think through their strategic direction in light of the current market context.

1. FROM PROFITABLE BUSINESS TO COMMODITIZED PRODUCT TO MARKET UTILITY?

Over the last years, some key traditional services have become commoditized and standardized with low prices/margins and little opportunity to differentiate. Is the next step for the industry to move to a "utility" model, like electricity providers? That is to say an industry characterized by standard products and prices, stringent regulatory requirements and, by default, limited number of providers.

Regarding standardization of products and services, there are already a number of key activities that appear to be highly commoditized and do not lend themselves to strategic advantage or differentiation:

- Settlement services in mature markets (The T2S standardization imperative will significantly accelerate this trend in Europe)
- Corporate actions because of the limited differentiation in the sources and uses of that information by providers
- Know your customer (KYC) given how repetitive and costly it is for each of the providers and how little value it adds to the end client
- Clients and product "reference data" that are duplicated across players

On regulation, we are already witnessing a very strong regulatory pressure on custodians aiming at protecting the financial system. For instance, eight of the top 10 asset servicing banks are considered SIFIs. While some are designated as such because of their size and importance regardless of their securities servicing business, several are designated purely because they are considered critical infrastructure to the world's financial system.

Add to this picture the level of the concentration in the industry with the top 10 players representing almost 70% of AUC and AUA globally, one is close to the "power utility" model in many parts of the value chain.

In this context, we believe that there are a number of activities that providers perform and deliver for clients that could lend themselves to being turned into (profit-making) utilities (see Exhibit 10). While there are the usual challenges in terms of set-up, governance, and standardization, some utilities have already started emerging in this space like the DTCC's initiative with a consortium of banks to consolidate and mutualize client on-boarding processes.

Exhibit 10: Securities services potentially eligible for utility

CORE CUSTODY

Clearing and settlement
- Listed and OTC clearing
- Bilateral and central clearing
- Cross-border settlement (EU)
- Domestic settlement in CSDs

Custody and sub-custody
- Global custody
- Local/sub-custody
- Safekeeping
- Corporate actions
- Income processing
- Tax reclaim
- Proxy voting
- Trustee

FUND SERVICES

Fund administration
- Fund accounting and administration
  - NAV calculation
  - Pricing
  - Reporting
- Compliance reporting
  - Solvency II

Fund processing and distribution
- Transfer agent
- Subscription and redemption
- Fund distribution

ISSUER SERVICES

Issuer services
- Issuer and shareholders services
- Escrow and agency services
- Depository receipts

ADJACENT SERVICES

Middle-office and reporting
- Portfolio administration
- Trade support
- Reconciliations
- KYC, account set-up
- Reference data
- Collateral administration
- Risk analytics
- Performance attribution
- Pricing

Liquidity management
- Securities lending and borrowing
- Collateral optimization and transformation
- Custody related execution (Forex)
- Cash management/treasury

Utility potential

KEY QUESTIONS FOR PROVIDERS

- Which specific functions and processes lend themselves to such a set up?
- Who would be the natural anchor/operator for the utility(ies)?
- Would the creation of such a utility possibly blunt the advantages enjoyed by the better operators in the industry? Where is your business in that spectrum?
- For participants, will the efficiency and cost gains as well as potential reduction in operational risk capital make up for additional integration costs? Are there "stranded costs" that would likely not go away – at least not in the first few years?
- Is there a risk of "disintermediation" by the utility? What are the strategic and governance steps necessary to mitigate that?
- Can the larger providers, particularly those with G-SIFI designation, turn that financial and regulatory handicap into an advantage in "risk absorption" capability, particularly in areas such as securities lending, collateral management, and the like?

2. DIVERSIFIED PLAYERS WILL HAVE A COMPETITIVE ADVANTAGE?

The overall trading and post-trading value chain (including execution, clearing, settlement, custody, fund and middle office services) is experiencing significant changes driven by regulations such as EMIR, DFA, MiFID and by new client needs. While the final equilibrium points and magnitude of these changes are still unknown, we expect increased use of electronic trading and clearing for derivatives products, a collateral shortfall creating needs in collateral management and transformation, continued demand for value added services such as reporting, risk management, valuation, and a potential market for integrated services (prime/custody, integrated execution and clearing).

In this context, the hypothesis is that players with capabilities covering the whole value chain (i.e. execution, clearing, collateral, custody and settlement) could develop a competitive advantage by developing new offerings in line with client needs, capturing new revenue streams and, in the process, enable internal cost synergies.

A number of players have already started moving towards that direction, either through public and formal organizational combinations or by building stronger links between their securities services and clearing/prime operations.

While we believe there are reasons this might bear fruit in the long term, it is far from being a "slam dunk" as there are issues to resolve and significant challenges to overcome to make these combinations successful.

We see five broad areas where an integrated offering and business could generate benefits for providers, recognizing the challenges associated in landing such benefits and the mixed results associated with prior attempts:

Front office/coverage: Improving coordination between sales and coverage teams could improve cross sell ratios between capital markets and securities services products across many client segments.

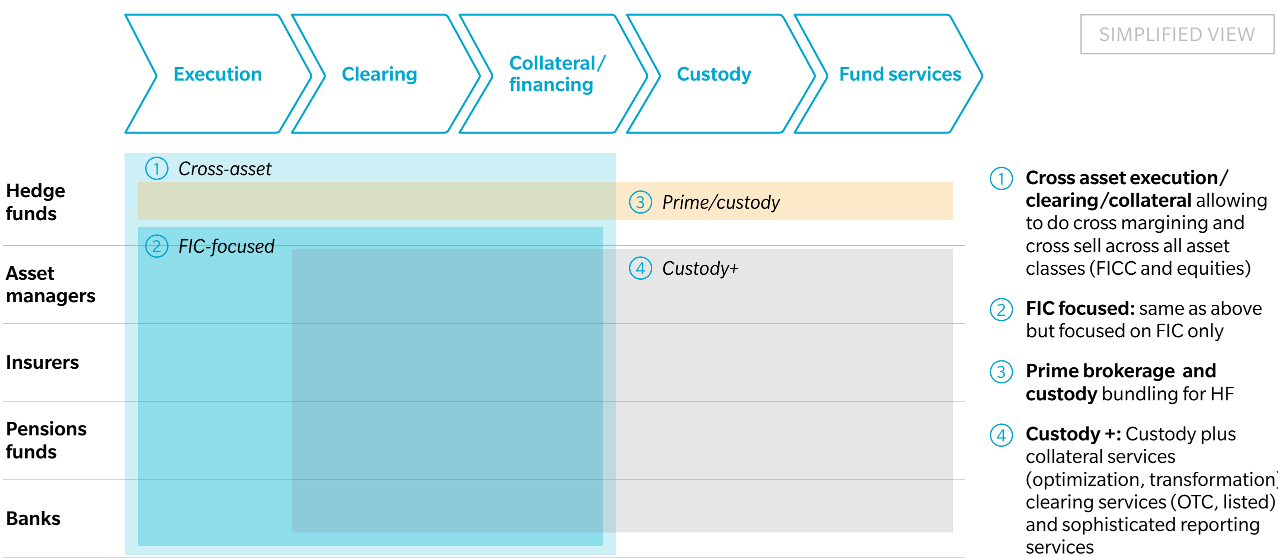
Product: In addition to potentially attracting new clients and/or making existing relationships stickier, combining and integrating product lines can also lead to potential synergies, particularly with respect to platforms and the product development and management infrastructure. New products can be developed by leveraging combined capabilities and expertise of siloed lines of businesses serving the same client segments. For instance, developing an integrated clearing and collateral management offering can help protect execution franchise and maximize revenues. Exhibit 11 includes examples of such potential integrated offerings, some of which are already in the marketplace, with mixed initial traction.

Technology and operations: The argument here is around rationalizing the overlap between many of the middle office and back office functions and platforms across the securities servicing and capital markets units, whether in corporate actions or collateral management or securities lending/repo.

Support functions: While this is unlikely to be the key driver, the cost synergies (at least on paper) of combining and rationalizing support functions like Finance, HR, and the like can be meaningful, especially if these are accompanied by senior management overlaps.

Funding and liquidity: As part of the operational activities of the custodian, clients hold uninvested cash that tend to be sticky and create a source of liquidity for the custodian. This source of liquidity could be optimized and maximized by designing more sophisticated cash management products with the capital markets/treasury business lines.

Exhibit 11: Examples of integrated offerings



1. **Cross asset execution/ clearing/collateral** allowing to do cross margining and cross sell across all asset classes (FICC and equities)
2. **FIC focused:** same as above but focused on FIC only
3. **Prime brokerage and custody** bundling for HF
4. **Custody +:** Custody plus collateral services (optimization, transformation), clearing services (OTC, listed) and sophisticated reporting services

Source: Oliver Wyman analysis

KEY QUESTIONS FOR PROVIDERS

- What is the magnitude of the synergies vs. the risks?
- On combined offering: how strong is the client demand for such offerings and what is the track record of integrated solutions in attracting new flows or deepening relationships?
- On sales/coverage: are the buying points at the client the same and if not how much of an overlap is there in terms of buying factors? Can the sales forces be cross-trained sufficiently to represent a significantly broader waterfront? If not, are there other means (e.g. account planning) to get more effective coordination?
- What are some of the potential downsides of an integrated custody/capital markets offering (e.g. perceived conflict of interests, client wariness about proprietary trading data)? Can these be addressed with robust Chinese Walls?
- To what extent can the synergies be captured through lower-risk actions (e.g. enhanced coverage coordination, joint pitching, and focus on cost levers through traditional approach) without the need for large organizational and platform changes?
- What are some of the other risks (e.g. cultural differences, uncertainty of the impact of regulation on integrated offerings) and how can they be mitigated?

3. OPPORTUNITIES OUTSIDE THE CORE MARKET?

Historically, securities services providers have focused on asset owners and asset managers (and, in the case of sub-custodians, on other custodians and intermediaries) as their core clients. While we expect these client segments to continue to drive and represent the bulk of custodian revenues, there may be opportunities for administrators to leverage their processing capabilities to tap into new segments and offerings. Specifically, serving banks and broker dealers outside of clearing and custody can represent a significant opportunity.

A specific example is the Broker/Dealer segment which is facing significant challenges that have created a need for greater efficiency.

Since 2008, ROEs for the industry have almost halved, leading broker/dealers to investigate new sources of efficiency and cost reductions. We also observe that the post-trade processing chain is duplicated across various players, requires significant upgrade investments, and brings limited competitive differentiation (see Exhibit 12). Finally, there are significant upcoming investments for regulatory requirements and market evolution (e.g. OTC reform, T2S, trade electronification).

In the meantime, a number of outsourcing/utility solutions dedicated for broker/dealers have emerged with many committed third party providers/vendors with increasing level of specialization and skills (e.g. DTCC/Clarient, FIS Capital Market IT utility, Accenture/Broadridge). These mature offerings for broker/dealers aim to mutualize and lower costs and future investments. Some broker/dealers have already implemented these solutions, creating "proof of concept" and credentials for the industry.

These changing market conditions on both supply and demand side are creating a strong rationale for alternative sourcing models, especially for banks that lack scale to reach a competitive cost-per-trade.

Many securities services players may be in a position to leverage their core capabilities to help broker/dealers optimize their middle and back office operations by insourcing some/all of those operations. This will create opportunities for securities services providers, as broker/dealers are trying to optimize the core and adapt historical business models to the new economic reality.

Private banks are another, albeit smaller, segment whose operational needs are not always fully met by the current offerings and require ever more complex services, including processing of separately managed accounts, tax services tailored to private clients, and cross border compliance reporting.

Exhibit 12: Post-trade outsourcing opportunities

ACTIVITY	RATIONALE/DRIVERS INCREASING OUTSOURCING OPPORTUNITY (INDUSTRY LEVEL PERSPECTIVES)	OUTSOURCING OPPORTUNITY
Clearing processing	• Required investment for OTC derivatives (margin calculation, connectivity impact…) • Bespoke clearing solutions by asset class • Listed solution nearing end of life	
Collateral management	• Bespoke collateral solutions for a number of business areas • Required investment due to OTC reform • Siloed account coverage and manual consolidation efforts	
Settlement	• T2S impact: standardization, need for enhancement/renewal of apps, processes, connectivity • Different securities settlement solutions by geography • Discrete OTC settlement engines across products	
Reconciliations	• Reconciliations – Low reconciliation auto-match rates – staff time spent – Different recs systems for different needs generating independent transaction references – Complexification: reconciling higher volumes of more complex trades	
Regulatory reporting	• Increasingly stringent requirements for regulatory reporting: real time or near real time reporting, data consolidation and aggregation	
Referential	• Reference data with no single "golden record" being available • Lack of data quality and standardization • Need access to local knowledge in different jurisdictions • Mutualization of investment in data analytics tools (big data, AI)	
Account set-up and management	• Increasingly stringent requirements • Costly and administration-intensive workload (collection) • No value added, same data across players	

Key: Low High

KEY QUESTIONS FOR PROVIDERS

- Which new client segment(s) represent an opportunity for our business? What is the size and the potential profitability of the opportunity? Is it sufficiently large to warrant the risks and the sustained investment commitment?
- How can we leverage our existing capabilities to sell products and services to these segments? What investments are required to upgrade our capabilities and skills to develop a competitive offering?
- Are there ancillary benefits? For example, can these new clients significantly add to our scale in the core business and lower our marginal cost?
- What are the most attractive targets for a "pilot"/"anchor" client?
- What are the risks and likely challenges? What are the key learnings from previous attempts?

4. SCALE IS OVERRATED, SPECIALIZATION IS IN?

Over the last decade, leading players have consolidated the market in search for scale to create a cost advantage for standardized services, which led to nearly 70% of AUC+AUA in the hands of the top 10 providers. Going forward, we do not expect major consolidation in the space (except in the alternatives servicing niche) as both industry dynamics as well as regulators (e.g. due to too-big-to-fail concerns) will likely limit the feasibility and limit significant additional consolidation.

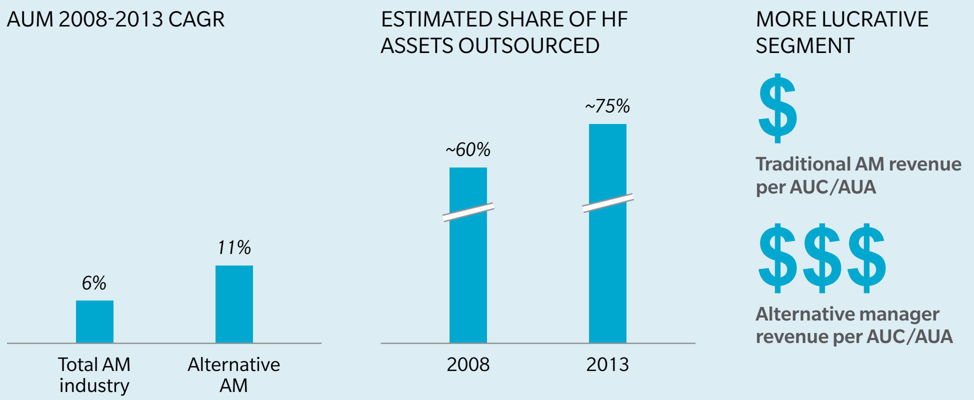
Another key reason that makes the scale strategy potentially less relevant today is the fact that clients needs are becoming extremely differentiated by segment (e.g. dedicated regulatory reporting for alternative asset managers (AIFMD), specific portfolio accounting for pension funds, tax services for private banks) and requires players to adapt and tailor their products, tools and processes to better address these needs.

In fact, we are seeing some of the large players publicly announcing their exit from select segments (e.g. Citi's plans to sell its hedge fund administration unit) given the intensity of competition and to better focus investments and resources into segments and geographies where they are better positioned to win.

ALTERNATIVE ASSET MANAGER FOCUSED STRATEGY

We have seen players (e.g. State Street, SSC GlobeOp) designing focused strategies targeting the attractive alternative asset managers segment (hedge funds, private equity funds, real estate funds). This segment has been attractive with an AUM growth significantly above traditional asset managers (11% CAGR '08-'13 vs. 6%). Alternative asset managers have also increased the use of third party administrator (75% for HF up from 60% in 2008), in order to focus on core business of managing and distributing funds. Hedge funds and other alternative managers also appear to be willing to pay a premium for value added and tailored services.

Exhibit 13: Focus on alternative managers*1 focused strategy



Source: HFR Industry Reports, ©HFR, Inc. 2013, www.hedgefundresearch.com, Preqin, Oliver Wyman analysis

*1. Includes Hedge Funds, Private Equity Funds, Private Real Estate funds

KEY QUESTIONS FOR PROVIDERS

- Which segments, product lines, and geographies represent the biggest opportunities, taking into account your starting position?
- What does it take to win in those pockets? Are the required investments worth the likely upside? What are the highest ROI niches? To what extent can you develop a sustainable competitive advantage in those particular pockets of opportunity?
- Are there ways to leverage the existing capabilities and tailor more bespoke, segment-specific offering(s) at lower cost?
- What are the organizational and business model implications of prioritizing a segment-specific approach to one that is based on product scale? What is the best way to manage the transition from a product-centric organization to a more client-centric model?

5. TECHNOLOGY AND DATA TO THE RESCUE?

Technology is the core of securities services industry. It is part and parcel of the service that is performed for asset managers and owners. We estimate the industry spends 30% of its cost base on technology. As such, technology is less an "enabler" (as it is considered in other wholesale financial services) but more of a "cost of goods sold". As such, the way securities services providers leverage technology has an outsize impact on client experience, product design, operating efficiency, and ultimately the financial health of their business.

Given the margin pressures we discussed earlier, many providers have been seeking ways to use technology to significantly improve their operating efficiency, rationalize their product platforms, and better manage operational risk.

In addition to this, over the last decade, there has been an explosion of data and our ability to process, store, and manipulate large amounts of it thanks to great advances in technology. Today, an average large securities services provider processes trillions of transactions and has hundreds of petabytes[4] of data. This combination of large amounts of highly specific securities data, combined with the ability to mine it with powerful tools at relatively low cost, represents a potential opportunity for providers to significantly enhance or even reshape their business.

We see this opportunity broadly in three buckets: First, and likely highest ROI, set of opportunities are around leveraging the information custodians have for better decision making and optimization of their own businesses. Examples include informing product development and bundling by looking at product usage and purchasing behaviors, optimizing pricing across products and clients, predicting attrition through automated early-detection mechanisms, etc.

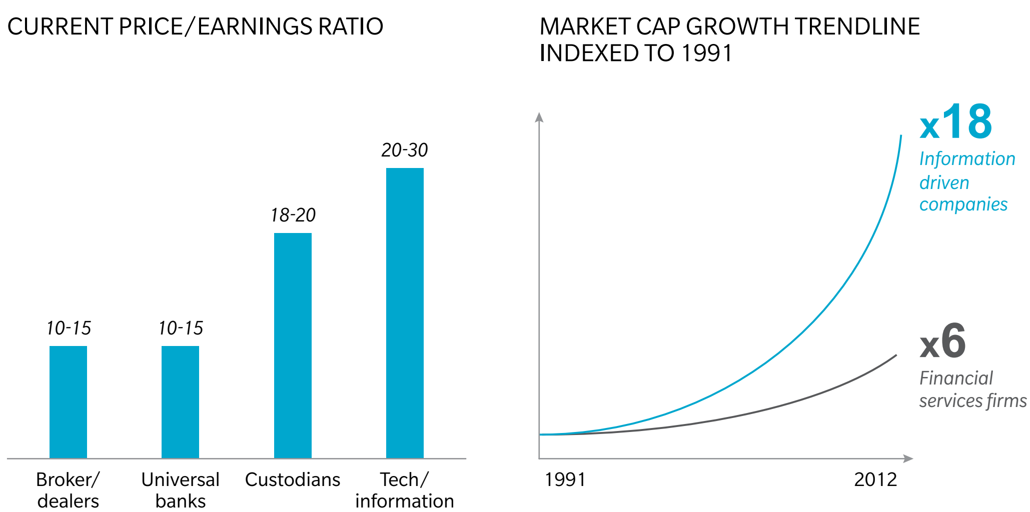
A second set of opportunities lie with using data for the benefit of clients, often by playing back their own data and, when appropriate, benchmarking against their peer group, whether it's portfolio analytics, risk and portfolio attribution, or simply key operational effectiveness metrics that securities services providers have available to them. State Street's recently launched GX Investment Labs product appears to be an example of such a platform.

The final "frontier", and typically the one that most practitioners mean when they talk about data, is turning data into a standard information product that may be valuable for clients or third parties (e.g. fund indices, industry flows).

As we had noted in the 2013 issue of our annual "The State of the Financial Services Industry" (SOFS) report and as Exhibit 14 shows, information-based businesses are much more highly valued by investors than financial services.

4 A petabyte is a million gigabytes which is estimated to be equivalent to 50 times the size of all of the contents of the US Library of Congress.

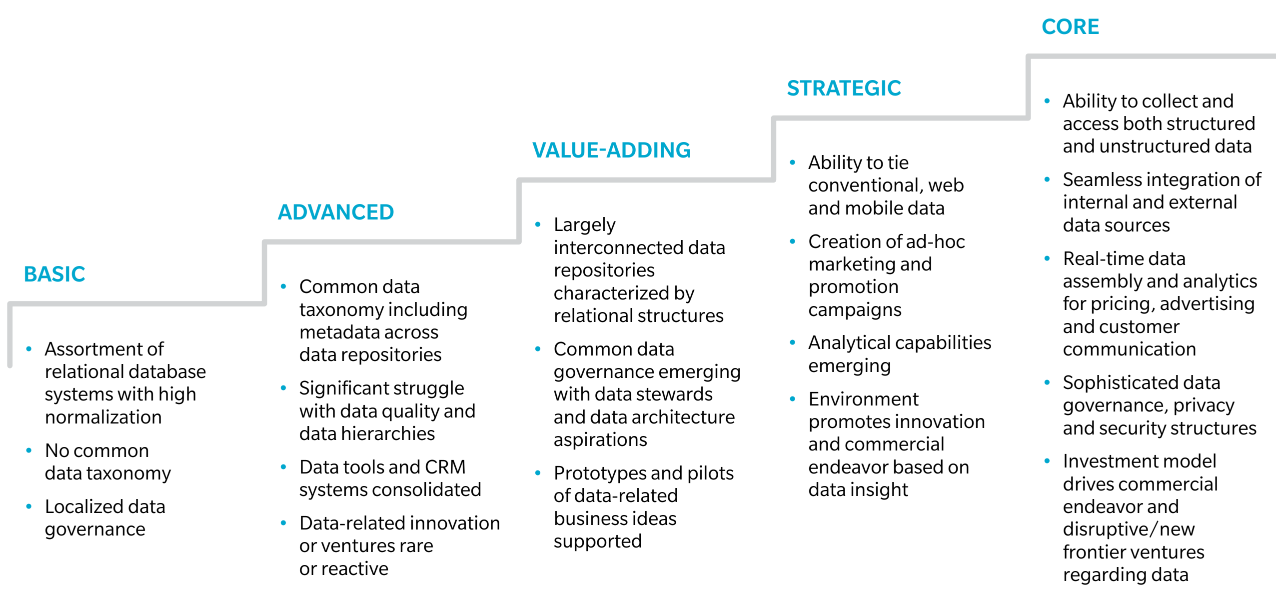
Exhibit 14: P/E ratios and market cap



Source: Datastream, SOFS report 2013, Oliver Wyman analysis

Some leading providers like State Street have launched dedicated units to capture this opportunity while many others have been exploring it more informally. That said, we believe most players are likely in the early stages of developing their capabilities and would likely place on the lower end of our "data capabilities staircase" (Exhibit 15).

Exhibit 15: Data capability staircase



KEY QUESTIONS FOR PROVIDERS

- What are the potential ways to leverage data in your business and to what extent can the provision of information and analytics be a core part of the business?
- What is the right approach to define and capture the data opportunity? How heavily should you be investing now, recognizing that this is a long term play? Are there any quick wins? What is the business case?
- Where do you stand in the data capability staircase? What is your "mark to market" with respect to technology capabilities and effectiveness? How automated are your operations vs. peers? What is the state of your IT architecture? Where are the key opportunities to improve productivity, reduce costs and better manage operational risk?

CONCLUSION

This is no longer the same securities services market we knew from 20, 10 or even five years ago. It has changed and will likely to continue to evolve in ways that make it imperative for players to take action. While no one can predict with certainty the direction the market will evolve, one thing is clear that status quo is unlikely to be an acceptable strategic option given the current pressures and the evolving regulatory, competitive, and client landscape.

It is therefore important for securities services players to define their strategic direction and take concrete actions consistent with that direction. The road to sustained growth and healthier margins is not straightforward in this complex and challenging economic and competitive environment, and there is not going to be a single, "one size fits all" winning strategy or business model going forward.

The right answer, as is usually the case, will depend on the provider's starting point, risk appetite, investment capacity and execution capabilities. The winners will be those who deploy a portfolio of strategic and tactical initiatives consistent with their own position and supported by facts and informed hypotheses.

LIST OF ABBREVIATIONS

AI – Artificial Intelligence

AIFMD – Alternative Investment Fund Managers Directive

ATS – Alternative Trading System

AUA – Assets Under Administration

AUC – Assets Under Custody

AUM – Assets Under Management

BPO – Business Process Outsourcing

CAGR – Compound Annual Growth Rate

CRD4/B3 – Capital Requirement Directive and Regulation 4/Basel 3

CRM – Customer Relationship Management

CSD – Central Securities Depository

CSDR – Central Securities Depository Regulation

DFA – Dodd Frank Act

ECN – Electronic Communication Network

EMIR – European Market Infrastructure Regulation

FATCA – Foreign Account Tax Compliance Act

FI – Fixed Income

FICC – Fixed Income Commodities and Currencies

FX – Foreign Exchange

HF – Hedge Fund

ICSD – International Central Securities Depository

IDB – Inter-Dealer Broker

ITO – Information Technology Outsourcing

KYC – Know-Your-Customer

LCR – Liquidity Coverage Ratio

MiFID – Markets in Financial Instruments Directive

MO/BO – Middle and Back Office

MTF – Multilateral Trading Facility

NAV – Net Asset Value

OTC – Over-the-Counter

ROE – Return on Equity

ROI – Return on Investment

SIFI – Systemically Important Financial Institution

SWF – Sovereign Wealth Fund

T+2 – Transaction Date plus 2-day Settlement

T2S – Target 2 Securities

UCITS – Undertakings for Collective Investment in Transferable Securities

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