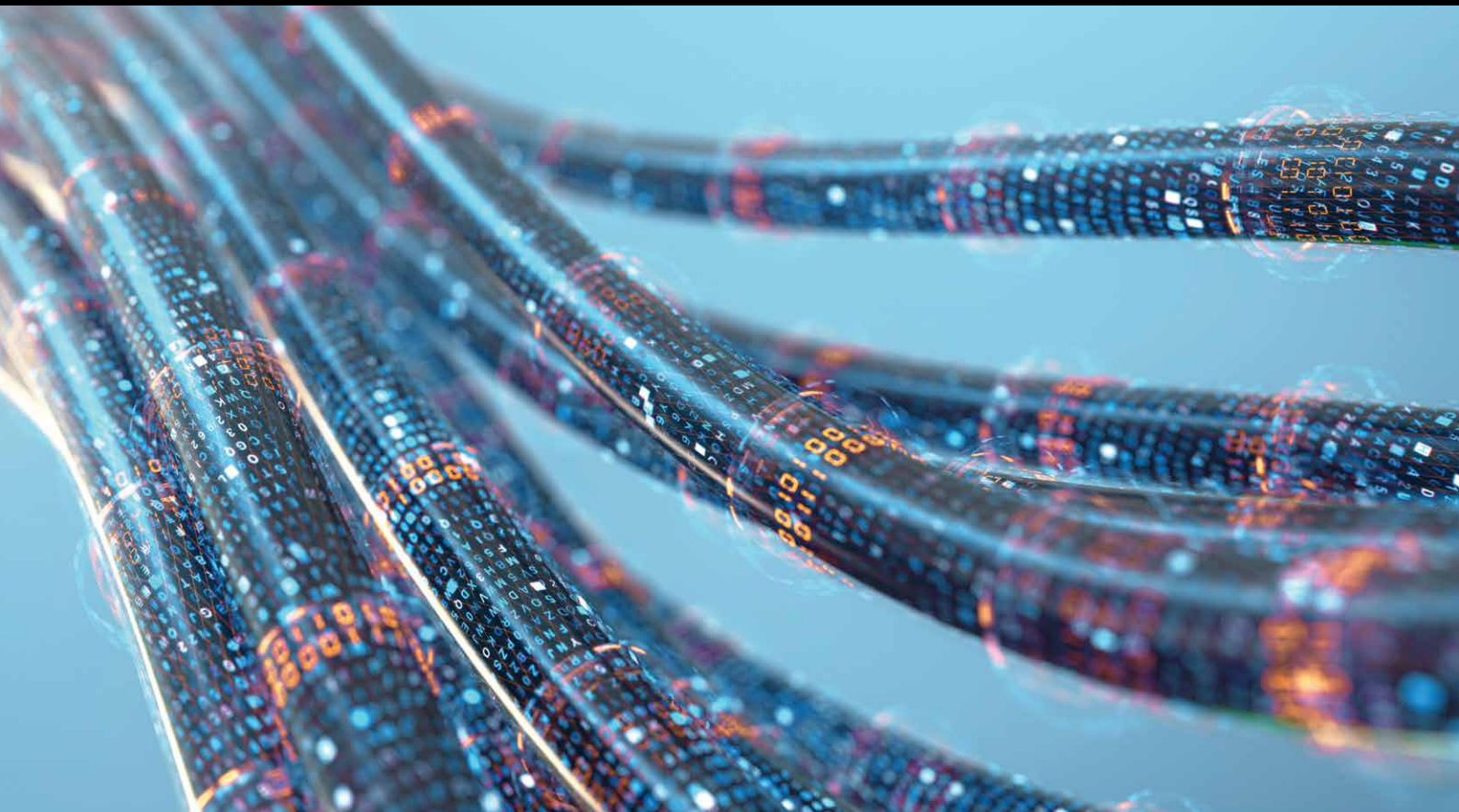




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Grey Costs Per Trade **Oversight, Hidden Risk and Opportunity**

June 2020



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GBST

Financial Services
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SIMPLIFYING POST-TRADE

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1. Introduction



What are your costs per trade?

In an era of investor protection, regulation, big data and cost cutting, it is amazing how polarizing that question can be.

Speaking with investors, brokers and banks across the industry, there is a consensus that we have no more than a 50%-accurate view of our true costs per trade. Obscured by human, technological and organizational factors, the question of measuring and managing your costs per trade is far from black and white. It is a world of grey. “An art, not a science”.

Drawing on insights from almost 200 investors, banks and brokers across the world in February 2020, this industry handbook reflects the challenges and priorities of our industry as they stood immediately before the massive consequences of COVID-19 began to be felt. In this context it is a summary of what we already knew to be important before newer and more urgent considerations around risk management and remote working came to the fore.

What we knew to be important in February is still key today – albeit alongside newer priorities - and this handbook is today a reminder of the considerations that should be driving our operating models in the months and years to come.

This campaign has been a truly industry-wide initiative, bringing together expertise from every sector and geography to help shape a new industry best-practice. We are very grateful for the support of GBST, Torstone, the Jersey Company, the Trade, The Network Forum and our expert contributors whose insights have shaped this report.

Together we hope that the actionable, statistical insights that we have identified in this handbook will help you to track your costs more accurately, to manage the risks in doing that and to take action in order to constantly improve your costs visibility.

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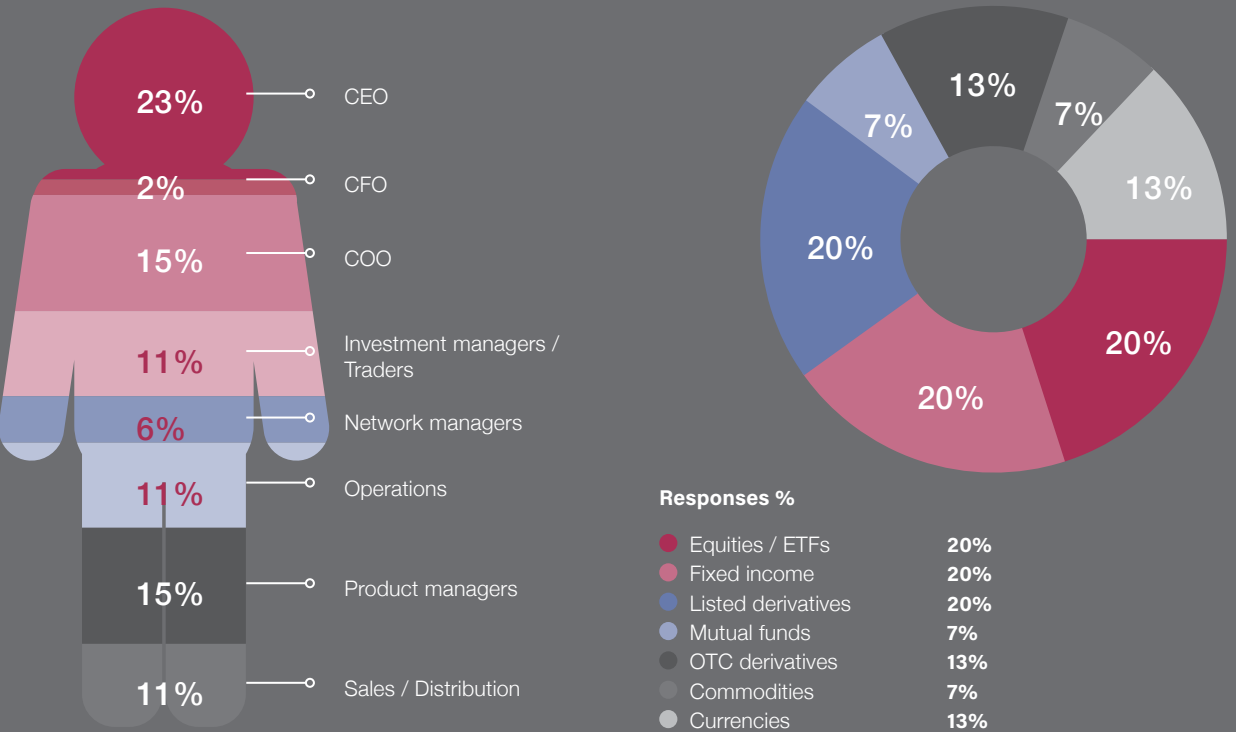
Who participated?

Regions

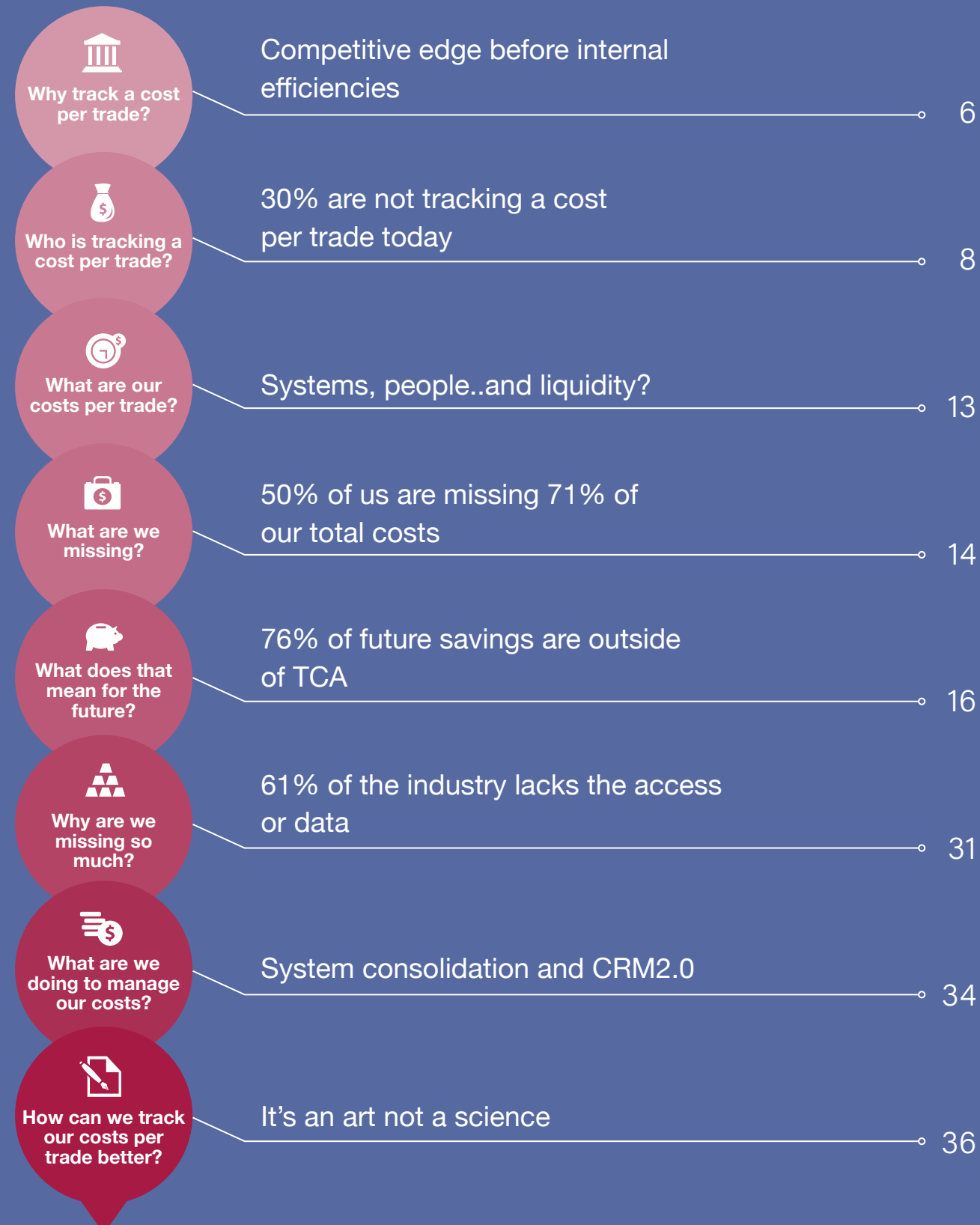


Positions

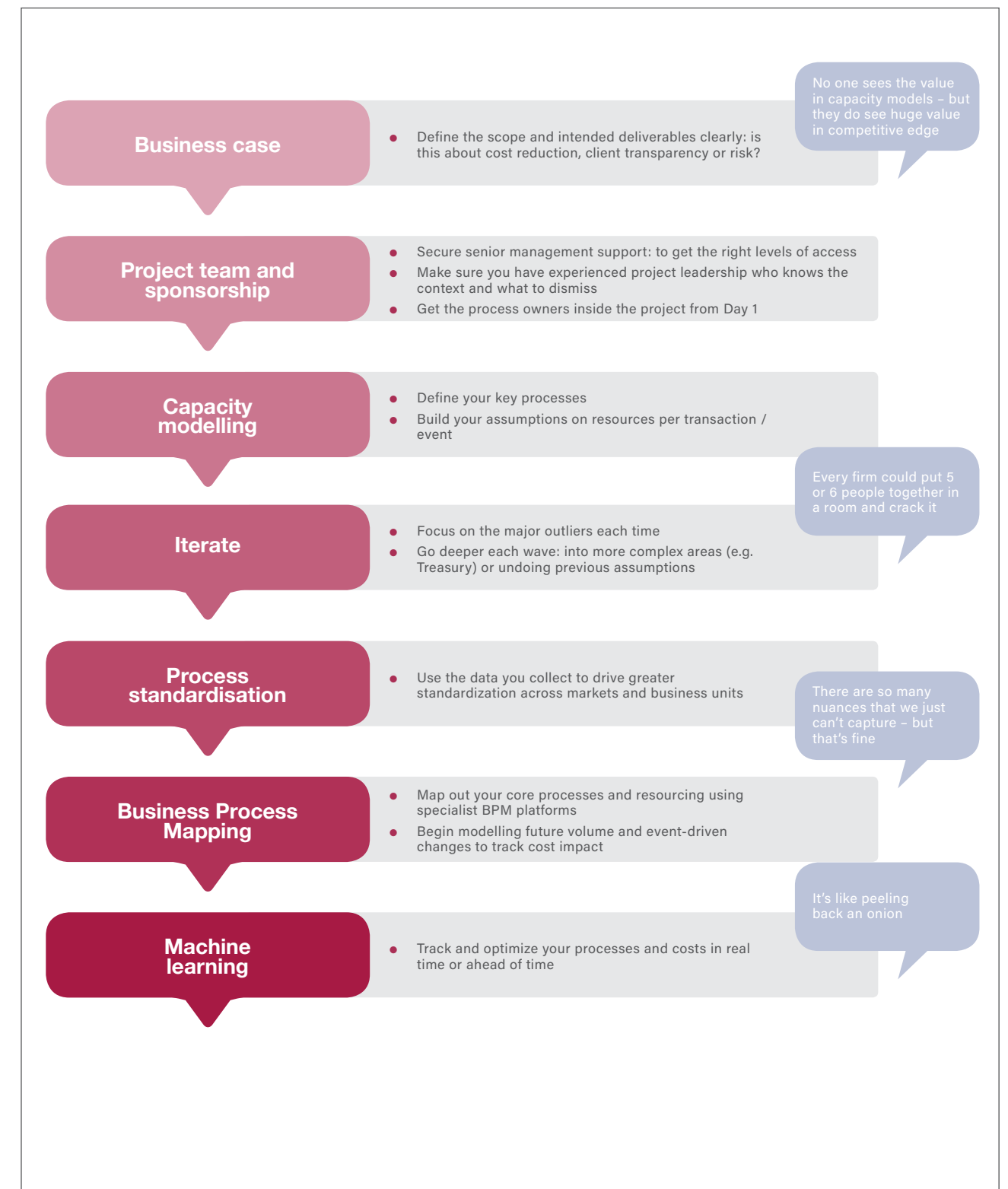
Asset classes



2. The Grey Costs Problem



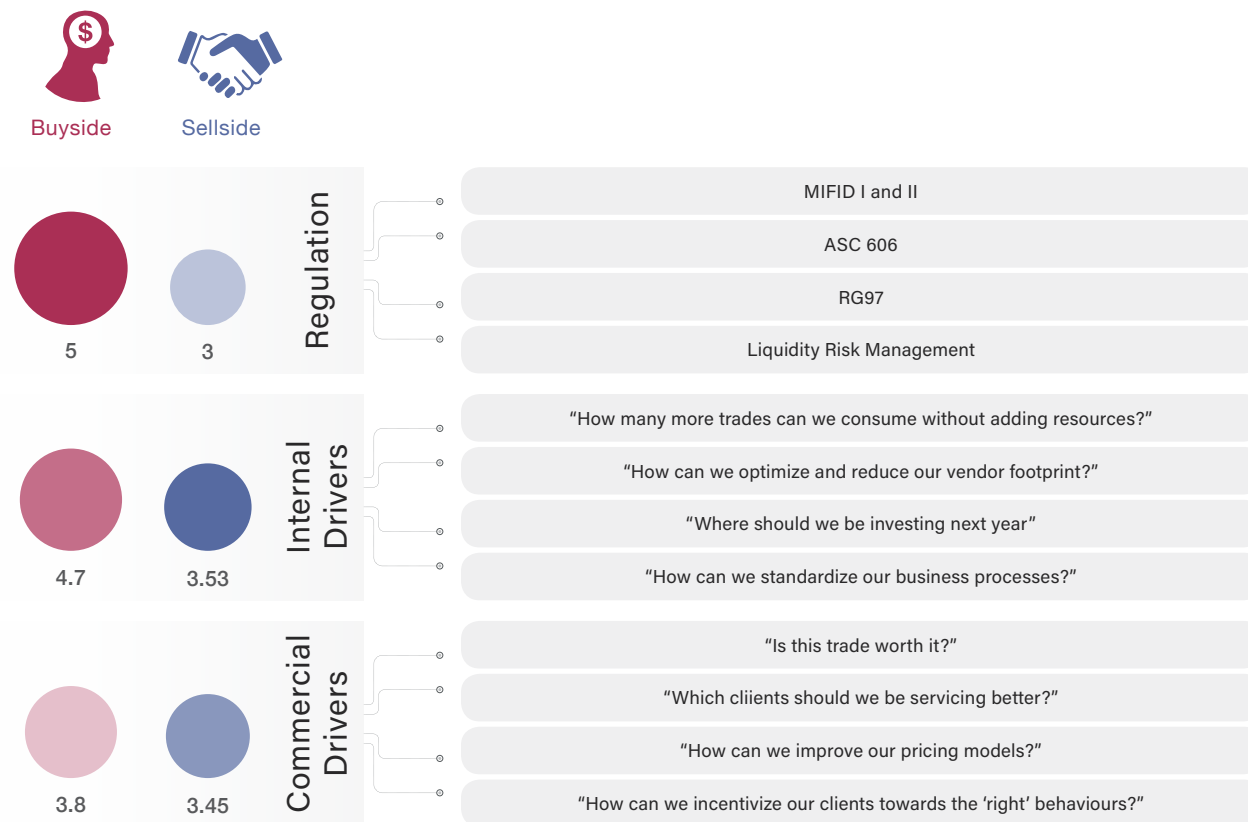
The Solution: Managing Costs per Trade



3. Why track a cost per trade?

Competitive edge before internal efficiencies

Why Track a Cost per Trade?



Many of us have spent the best part of the last 10 years tracking this subject. First came the Global Financial crisis and a need for rapid and dramatic cost-cutting; requiring new levels of clarity on trading costs. Then came regulations such as MIFID: which required the industry to begin uniformly tracking our execution costs. Customer propositions such as outsourced clearing and middle / back office outsourcing have since targeted the cost per trade as the central axis of their value proposition. And now large investors are demanding to see granular cost information from their counterparties in order to monitor and model performance.

Whatever the prevailing mood, priority or regulation, transparency over costs per trade is always fundamentally relevant – and it is no surprise that today 71% of the industry sees costs per trade as an important metric: but what is driving that focus in 2020?

Investors: More than just MIFID?

Regulatory compliance and transparent costs per trade are one and the same thing for investors, who give "Regulatory Compliance" a 5/5 rating as a driver to track their trading-level costs. Driven originally by MIFID (and now by Reg97 ASC 606 and others), the buy side has invested heavily since 2008 to achieve uniquely high levels of visibility on their execution costs.

Yet whilst "about half of investors still see their TCA reports as a check box exercise" (with little or no business application of the data), a growing number have begun to move beyond regulatory compliance: realizing as they have the critical importance of cost transparency in driving competitive edge in performance and distribution.

Brokers: From cost control to competitive edge

Given the transactional nature of brokerage, trading costs are central to a broker's business - and so it is no surprise that 80% of brokers see the management of their costs per trade as key.

The combined effects of regulation, unbundling and the move to passive have driven an existential focus on costs per trade – with brokers tracking and reviewing their unit costs on a continual basis. "We have to come with new answers on cost control every week now."

But whilst cost control has been (and continues to be) largely internally focused (rated 4.7/5 as a driver), the central value of costs per trade tracking has now moved beyond simple cost containment – to become a central part of brokers' competitive proposition. The cost per

Costs per trade data = the best venue for our next trade

In a world of intense competitive and pricing pressures, these more advanced (and typically larger) investors are looking beyond their asset value-based Total Expense Ratio calculations to understand their own transaction costs - in an effort to reduce the drag that high transaction costs can have on their overall funds' performance. The growing appearance of buy-side names in colocation centres around the world's exchanges is clear evidence that Tier 1 fund managers are willing to invest significant resources to monitor and optimize every element of their trading costs in an effort to carve out a new edge.

On the distribution side, the unit costs for highly transactional businesses (notably retail and passive fund managers) underpin their entire competitive position. "Cost efficiency and risk are our only competitive edges," (said a large fund manager in Hong Kong).

trade has moved from a back office operational metric to being a front office weapon: the foundation for pricing strategy; for client and trade profitability analyses; and even for sharing with investor clients to help model and manage relationships. This is especially so in APAC (where the sell-side sees accurate cost per trade tracking a driver of internal metrics and competitive advantage in equal measure).

Equally these metrics are moving from post-trade today to (aspirationally) pre-trade tomorrow. Several brokers have stated their desire to move to a state where "real cost per trade data should be able to tell us the best venue for our next trade, given infrastructure costs, collateral costs, different haircuts... the whole lot". Whilst this has yet to be realized at scale, the accurate tracking of costs on a per-trade level are clearly an increasingly accepted and relevant weapon against the growing complexity in trading venues and execution methods - and a key tool for survival.



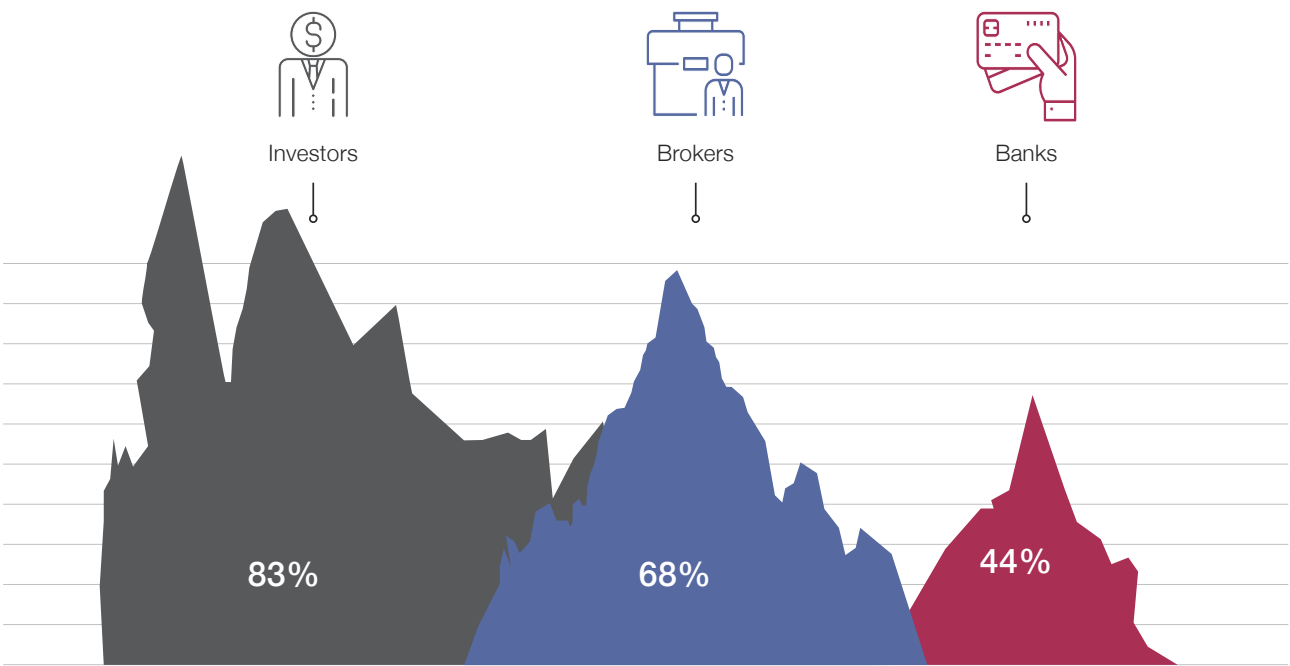
4. Who is tracking their costs per trade?

30% are not tracking a cost per trade metric today

Despite the growing acceptance of costs per trade data as a competitive enabler, it is surprising to see that a full 30% of our industry is unable to see volume-based trading analytics on a regular basis

In the absence of transparent cost per trade data, how is a third of our industry making properly informed decisions on ideal staff behaviours (and rewards); how solid are their investment decisions; and how accurate are their strategic roadmaps? The absence of visibility in this space is giving rise to serious risks.

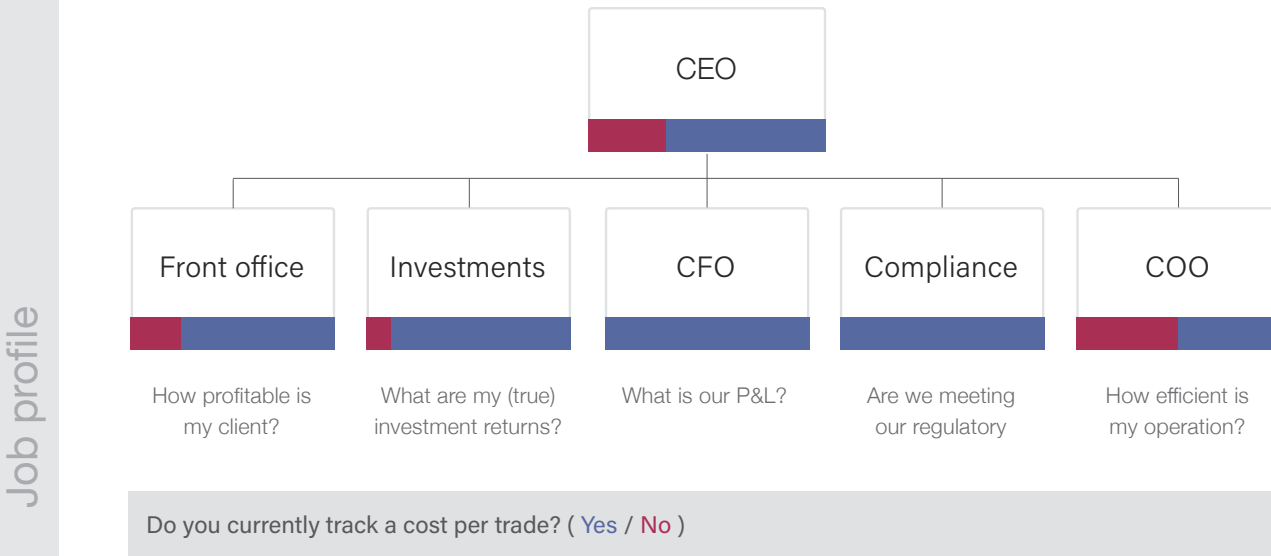
Who is tracking a cost per trade today?



“It’s all about **feeding the P&L owner**”

Cost per trade data is considered most important by and consumed most in the front office today: amongst CEOs, Heads of desks and investment managers. These are the consumers for whom costs per trade are most meaningful: preoccupied as they are by profitability and volume-based P&L.

Who is seeing cost per trade data today?



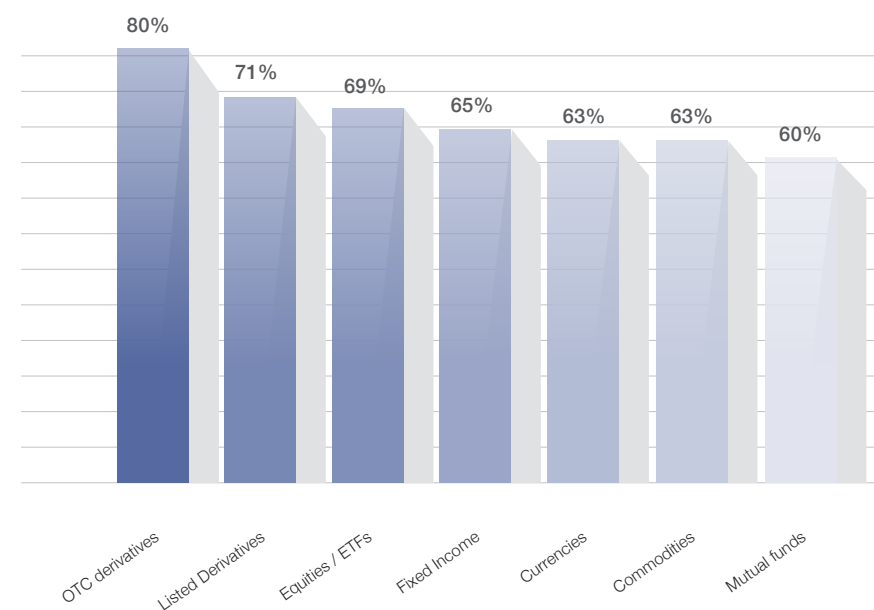
In their role as the largest consumers of this data, they are also the main champions for driving this transparency within organisations. The active support of front office, senior management is key differentiating factor between organizations that have and have not made progress in this area. “It’s a question of determination” after all.

Yet interest in this information dissipates quickly as we move from the front to the back office: with only around 50% of COOs and Heads of Operations receiving costs per trade data regularly. 14% of COOs even go so far as to say they see ‘zero’ value in tracking a cost per trade. As one COO explained “we don’t control volumes and so our job is to focus on minimizing our absolute costs”. Yet conversely, it is hard to imagine any COO who wouldn’t have been paying close attention to the linkages between volumes and costs during Q1 2020, as they sought to avoid disproportionate volume-driven cost spikes across their business. Costs per trade may not always be the primary metric but their broad importance is hard to overlook.

How profitable is the next structured product trade going to be for you?

The importance of good costs per trade data varies by asset class too. Whilst the costs of managing exchange-traded and centrally cleared instruments are relatively transparent (the use of cost per trade data in the derivatives space far exceeds that of any other asset class – at 75%), the need for greater visibility is more acutely felt in the mutual funds and structured products spaces (where visibility is only 57%).

Where is cost per trade data most used: by asset class?



In these high-growth areas, true trade costs and unitized profitability measurements are made difficult by the large range of manual tasks and fixed costs (such as fund-house onboarding, legal documentation, etc.): creating a blockage to volume-based cost management. This lack of transparency is becoming an increasingly acute problem for banks and investors, as they turn to these asset classes in increasing numbers to drive growth in the years ahead.

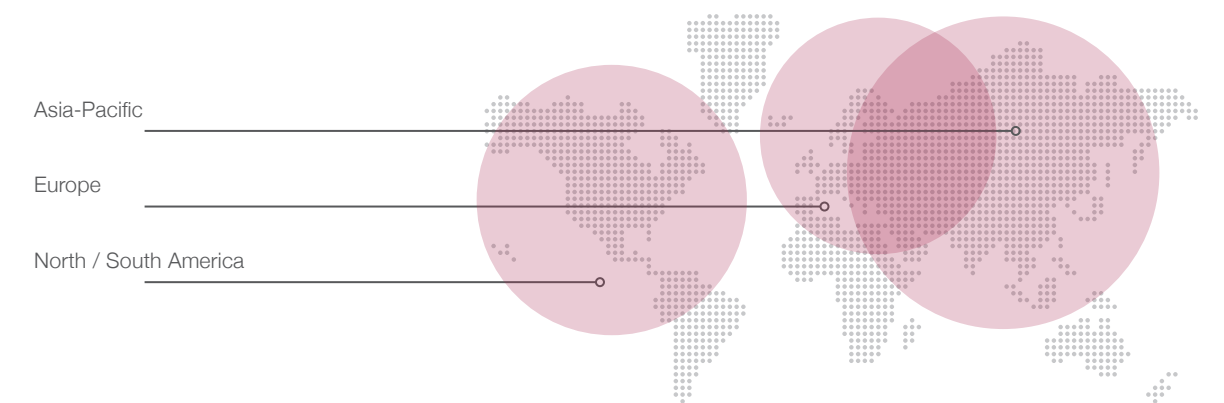
To see more insights on how DLT is providing higher levels of transparency across specific asset classes, visit our “DLT in the Real World” report at thevalueexchange.co/dltintherealworld

Equally only 50% in Europe see it...

In one of the more surprising statistics from this research, a full 45% of respondents in Europe are not seeing a cost per trade metric regularly, versus only 23% in Asia and 29% in North America. As the region that sees the least competitive advantage in transparent, cost per trade management, Europe is perhaps missing the commercial incentive.

However, it is equally likely that, after successive regulations in this space, “Europeans hold themselves to a higher standard” of costs per trade management.

Where is cost per trade data used in the world?



Whilst the costs of managing exchange-traded and centrally cleared instruments are relatively transparent, **the need for greater visibility is acutely felt in the mutual funds and structured products spaces**



Tracking costs per trade: Not when you’ve outsourced?

5. What is the cost of a trade?

50% of our industry is tracking only **29% of the total costs of a trade**

TCA vs TCT: What are the buy-side’s costs per trade?

MIFID II has given investors significantly greater (and more uniform) visibility of their execution costs than ever before. As a new data standard (of sorts) TCA is demonstrating the value of data-based insights, helping investors to source and compare (semi-)standardised data across multiple brokers and markets to manage their choices of algos, trading venues and brokers worldwide.

But it is important not to over-state the role of TCA as a metric for cost measurement across the trading cycle.

Based on our research, a TCA-driven view of costs (essentially Broker fees + Liquidity impact + Cost of research) reflects only 54% of the total cost of a trade (24% when you exclude broker commissions) – and overlooks many of the largest costs per trade today.

Given this significant difference, it is worrying to see that approximately 50% of investors are using this TCA-based definition today as the basis for what they would call cost per trade management. Even the most diligent investors (who make up less than 25% of investors) track only 14 cost elements as meaningful (versus 19 on the sell side): showing a surprisingly simplified approach to cost per trade management across all of the buy side. Anecdotally, few TCA providers “have even been asked” to incorporate post-trade costs (for example) into their analytics.

This means that 50% of investors are failing to take into account their unitized costs of IT systems and staff, for example, which constitute 27% and 12% of the total cost of a trade respectively. Although these elements are doubtlessly tracked at an absolute level, the absence of unitized costs across half of the market exposes key risks in how key trade offs (between systems and people) are managed – and whether or not the industry is to scale its volumes.

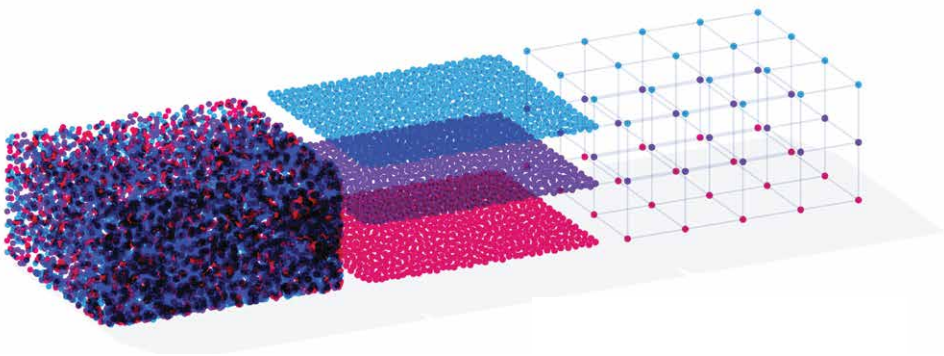
The buy-side view

Outsourcing

At first it is surprising that those who have outsourced their middle and/or back office operations track their costs per trade less than those who have not outsourced (67% versus 100% on the sell side; and 47% vs 82% on the sell side).



Yet these statistics actually reveal a core benefit of outsourcing – in that it removes the need to monitor and calculate a large number of costs per trade (billed as they are on a unit basis by the outsourcing provider). Rather than being negligent in their management of costs per trade, around 50% of brokers have outsourced not only their operations but also their cost-per-trade management.

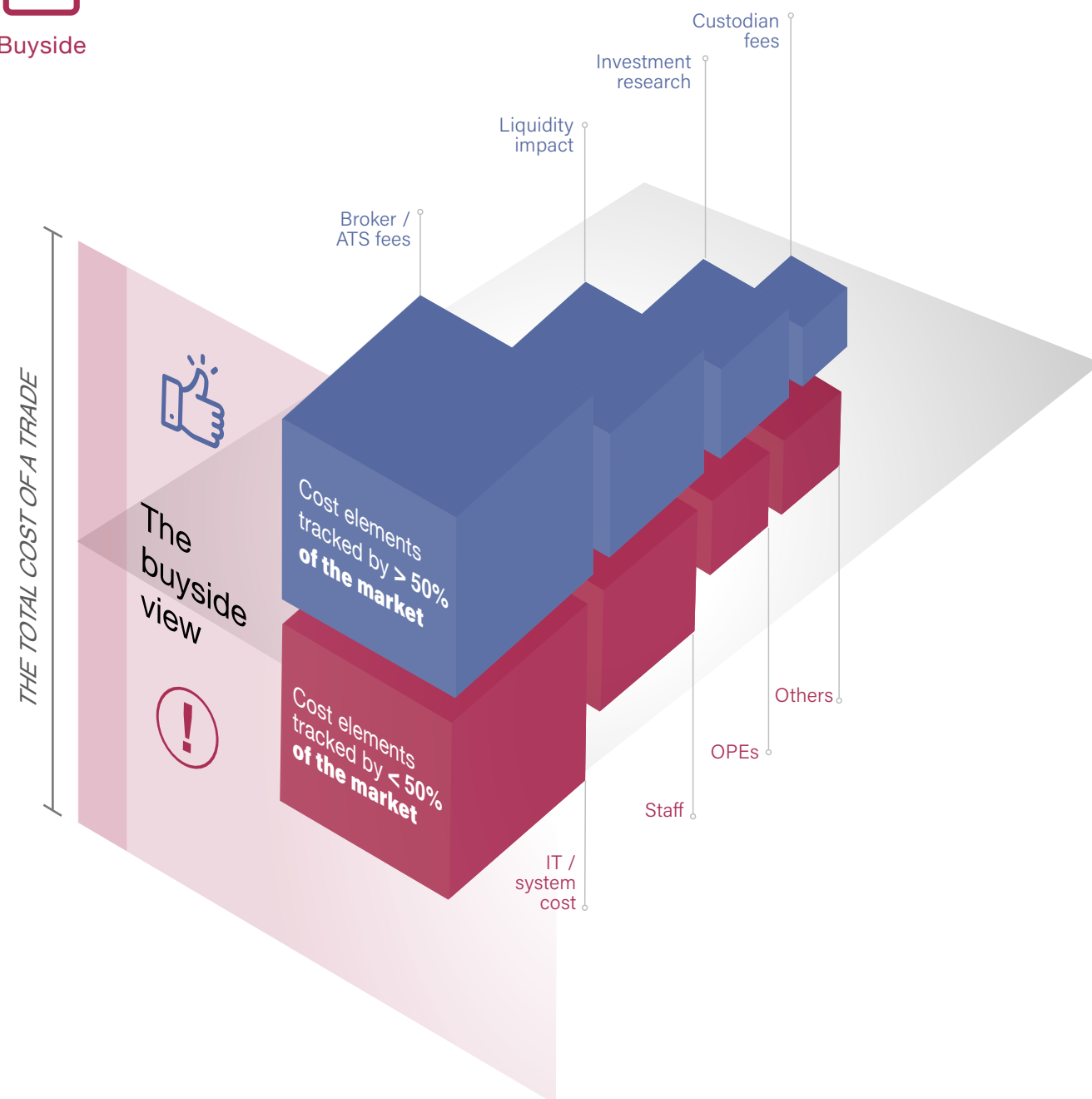


We don’t control volumes and so **our job is to focus on minimizing our absolute costs.**
– (COO of a major brokerage)

What are the buy-side's costs per trade?



Buy-side



The TCA-based view reflects only **54%**
of the total cost of a trade”

Grey costs on the Buy side

Digging deeper into these costs, trading and execution fees are double the cost of research (24% and 12% respectively); raising the question of whether the true value of a trade research is being accurately compensated for.

But few costs of a trade could be more grey than out-of-pocket expenses (OPEs): which are estimated to cost 7% of a trade (versus custodian fees, for example, that make up a mere 5% of costs per trade). In contrast with custodian fees, these highly opaque costs (including everything from courier fees to market charges) have gone unscrutinised for many years, despite recent legal cases highlighting the significant risk of abuses in this space. Given these much publicized risks and the high perceived cost of these expenses today, it is concerning that less than 25% of investors are tracking out of pocket expenses on a regular basis as part of their total costs per trade. “Perhaps OPEs will follow the same path as FX costs where “a few big examples of market abuse were enough to make the whole market track costs overnight.”

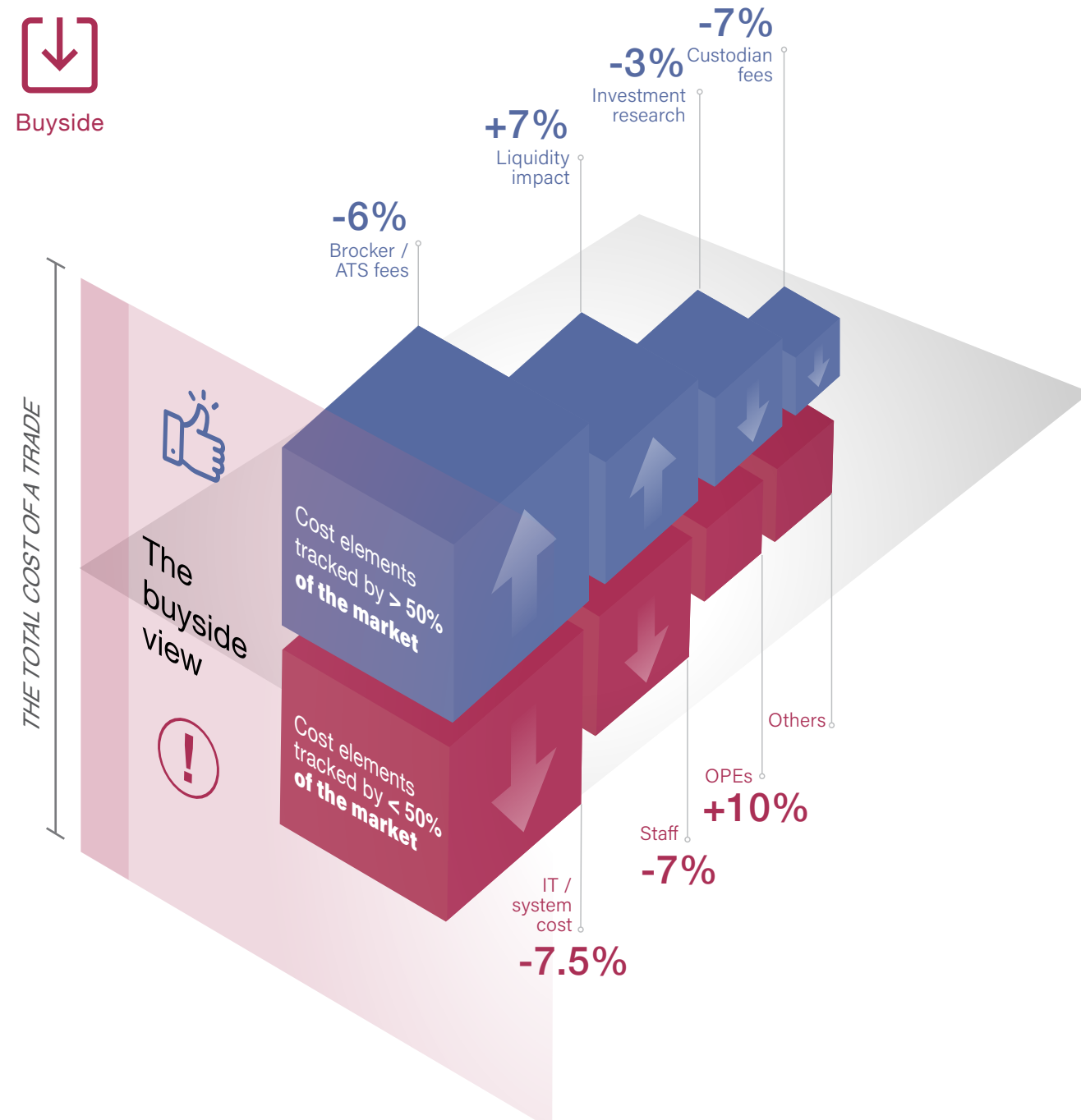
Equally important are the cost elements that are not part of the simplified, investor perspective on costs per trade. Following the Woodford scandal, Liquidity Risk Management (i.e. provisioning for significant liquidity events, such as a run on redemptions in a fund) has been a key area of focus for regulators and fund managers alike. It is also the #1 area of focus for the sell side (ex-APAC). Yet the costs of these provisions (i.e. the cost of capital, funding lines and the operational processes to support them) are conspicuously absent from investor’s cost per trade methodologies today.

With more than half of investors overlooking 46% of the costs of a trade, there is no doubt that TCA is both a boon and a challenge to the buy-side. On the one hand it is an invaluable example of the power of market-wide data, but on the other it risks driving a significant distortion in cost perspectives: which means mis-represented total costs, incomplete business cases and additional risk to key decisions. Is TCA really delivering the investor-protection and true, best-execution that it was designed for?



What does that mean for the future?

Future costs per trade on the buy side



76% of future savings come from outside of TCA

“In an era of intense revenue pressures, investors have massive expectations of cost savings to come: **expecting their total costs to diminish by 57% over the next 5 years.**”

Only liquidity impact and regulatory development costs are expected to grow. This compares with a total cost increase of 38% at brokers; and 34% at banks (see p.XXX); with the buy-side clearly expecting their sell-side provides to absorb many areas of cost increases (such as buy-in charges) in the next 5 years.

But there is an enormous gap between how investors see their future savings. Those 50% of investors who see trading costs through the narrow lens of TCA will track and measure a 9% reduction in their costs per trade over 5 years. However, the diligent minority who track the full range of 14 investor-cost-elements will forge ahead of their peers as they track a reduction of 48% in costs, thanks to their closer oversight of such costs as out-of-pocket expenses, staff costs, IT and system costs and premises costs.

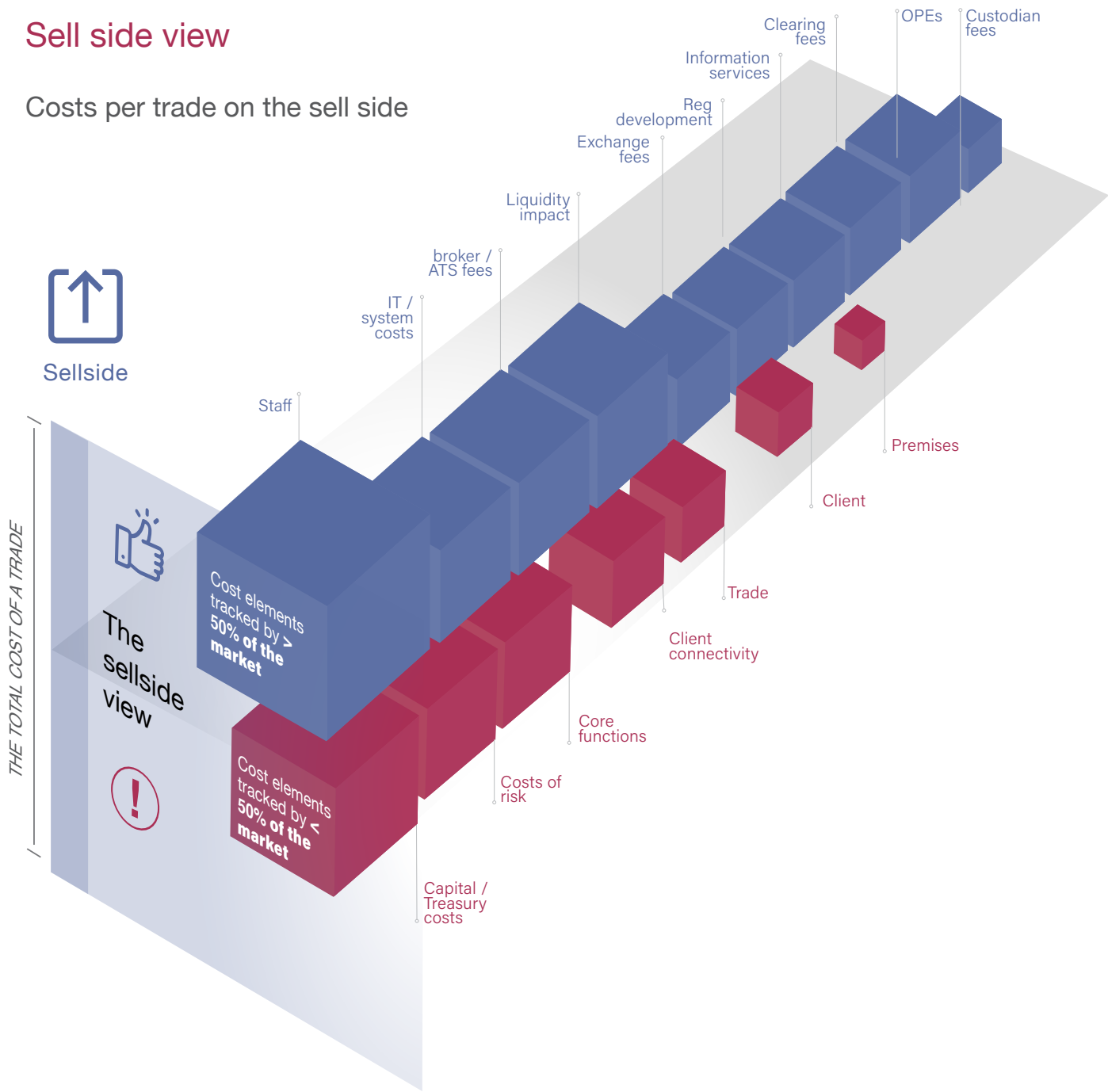
Close attention to investors' costs per trade can yield a competitive edge of up to 39% over the next 5 years.





Sell side view

Costs per trade on the sell side



What are the Sell-side's costs per trade?

Given the existential importance of costs per trade for brokers (in particular), it is no surprise that the sell side maintains a much higher degree of visibility on their costs per trade than the buy-side: tracking a total of 19 elements (vs 14 on the buy side).

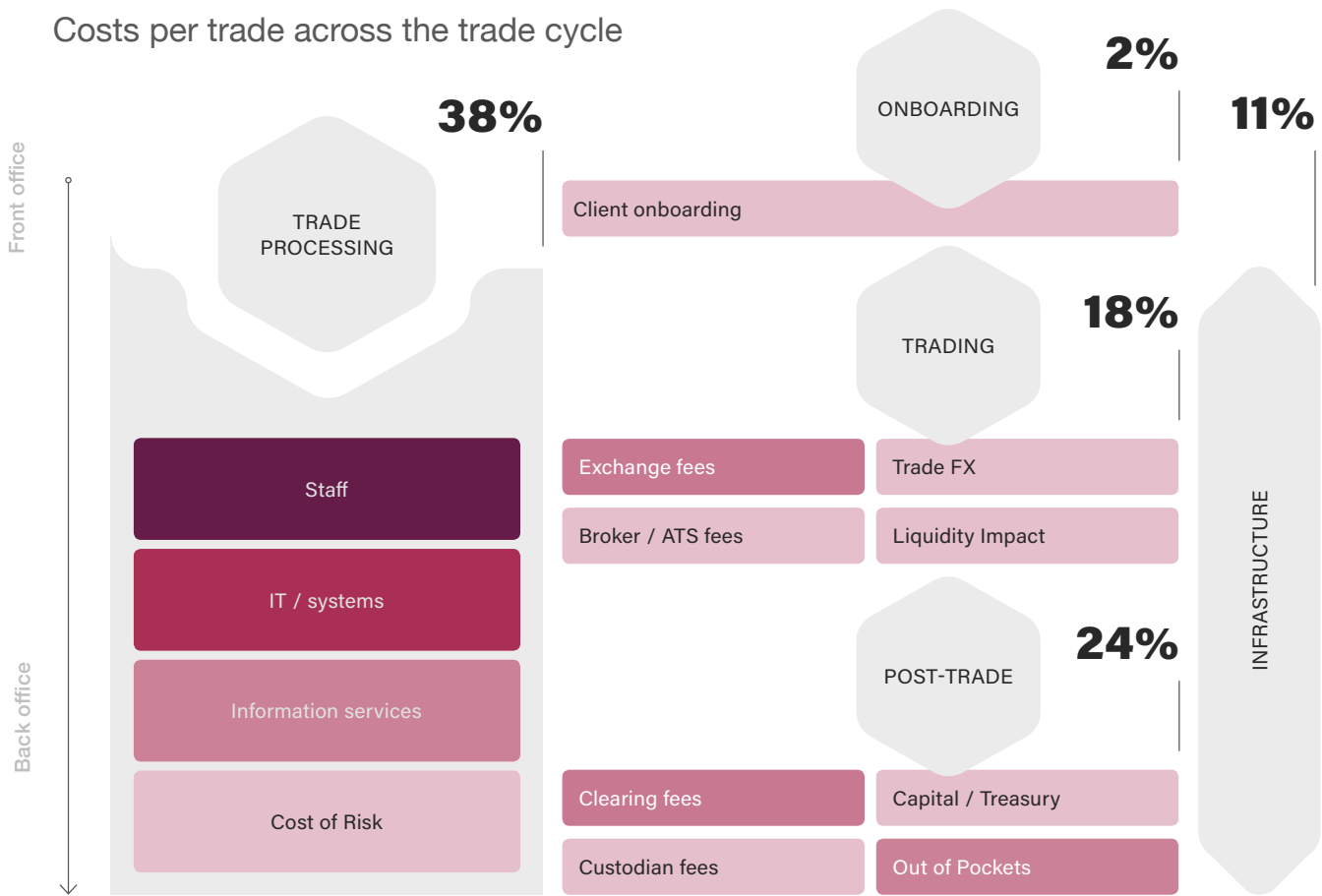
The sellside view

Of those, the top 4 costs (staff, capital and treasury costs, the cost of risk and the cost of IT/ systems) make up 40% of the total costs per trade: with brokers primarily focused on staff costs; and banks prioritising capital costs. Despite years of algos, automation and cost pressures, it is interesting that brokerage has remained a people-business above all.

Yet a similar challenge exists to the buy-side in terms of how costs are being tracked and measured: with 50% of the sell side tracking only 62% of the total costs of a trade. Whilst both banks and brokers are adept in tracking costs that are unitised and directly billed to them (such as exchange fees, clearing fees and custodian charges), they struggle much more to measure the impact of fixed or allocated costs (such as the cost of capital or risk) on their total costs per trade. Worryingly, half of bankers claim not to be tracking their single largest cost (the cost of capital) as part of their costs per trade – not to mention the costs of compliance, buy-ins or information services.

In an era of intense price competition, this level of oversight is surprisingly acceptable, despite its significant implications in terms of the accuracy of decision-making on the sell-side. “Yes, [tracking] about 60% [of our total costs per trade] sounds about right,” has been a common refrain in discussions on this topic – due mainly to challenges around unitising many of the more complex costs.

Costs per trade across the trade cycle





The sellside view

It Costs more to clear a trade than to execute it

In the lifecycle of a trade, trade execution makes up only 18% of the cost of a trade globally – whilst the post-trade space constitutes 24% (driven largely by clearing fees and capital costs). Historical data would no doubt show a transfer in the last 20 years as the costs of capital and liquidity have risen faster than the costs of execution – a trend that is expected to continue in the near future, where trading costs are set to decline by 2% and post-trade costs set to increase by 2% (creating a 4% jaw effect).

Of course, true costs per trade depend largely on the nature of the brokerage flow. Surprisingly electronic flows (including HFT flows through

to standard DMA) head the list in terms of cost complexity given the increasing levels of regulatory oversight and protections that are needed to monitor and control orders. Despite their seemingly manual nature, voice- or care-orders seem to attract lower costs overall.

But these costs pale into comparison against the costs of trade processing (i.e. the systems, the people, the data and the cost of risk that underpin the entire trade cycle): which make up 49% of the total costs per trade globally. With an expected growth rate of 14% in the next 5 years, it is no surprise that organisational focus has universally shifted towards this key area: as banks and brokers seek not just to carve out competitive advantage through cost management – but simply to stay alive.

Costs per trade in Asia are the most concentrated: with staffing costs, IT/systems costs, exchange fees and clearing fees making up 60% of the cost of a trade (versus 30% in the rest of the world). Asian exchange and clearing fees are seen to be between three to four times higher than elsewhere in the world. Equally, the cost of IT systems is double that of European and North American peers, due largely to the number of Asian markets that require locally managed systems.

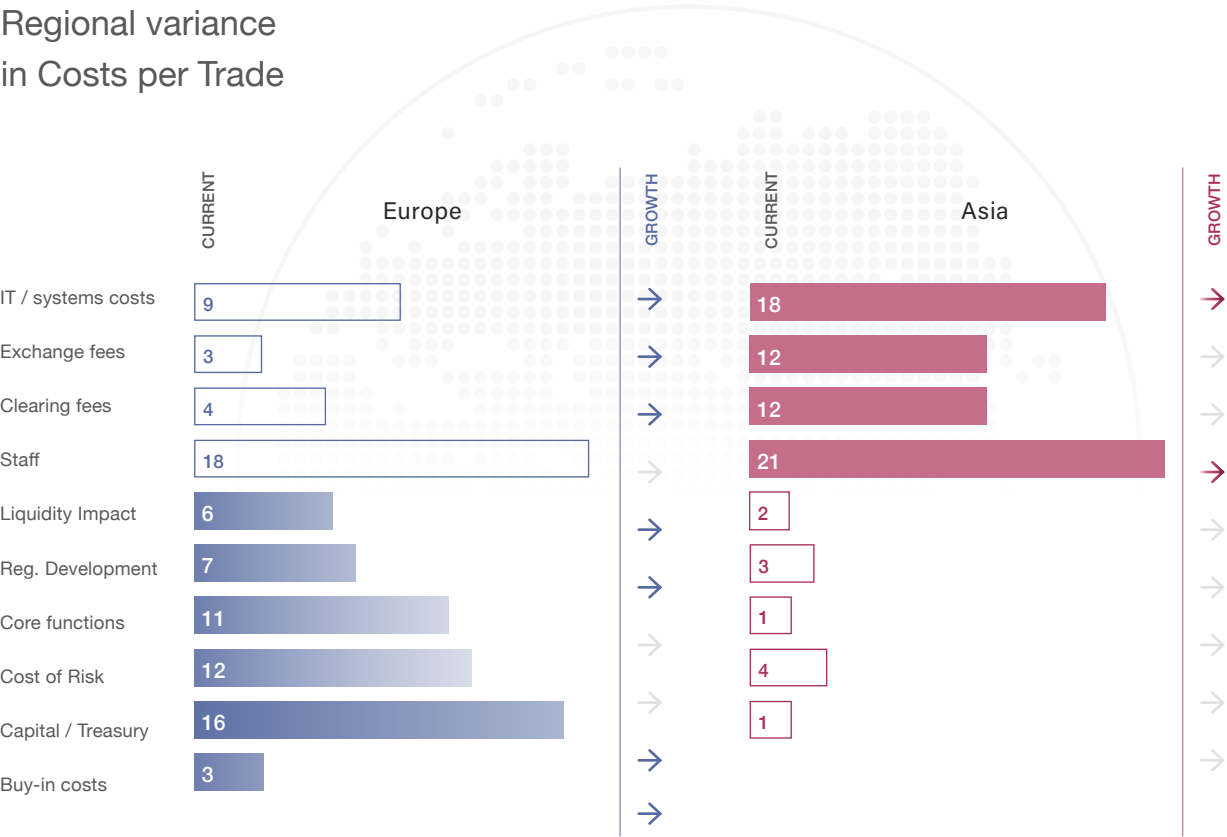
In Europe and North America, the cost of capital is the leading cost of a trade (at 16%), underlining a deep awareness of the true costs of (intraday) liquidity and capital in today’s post-Basel world. Our study shows most Asian banks and brokers to be almost entirely oblivious to those costs however, estimating them to be 1% of total costs per trade – despite Asia having some of the most costly regulatory capital regimes on Earth.

Equally, the cost of risk (which also broadly includes the cost of compliance and legal, the cost of regulatory development and buy in costs) make up 32% of the cost of a trade in Europe and North America. In Asia, risk makes up a mere 9% of the total cost per trade.

So why aren’t brokers and banks in APAC worried about the cost of capital and risk? In part this difference can be explained by the fact that most trading in Asia is done using UK- or US-based balance-sheets (e.g. by Plc or LLC entities), wherein the cost of liquidity (and risk) is measured in London or New York. Nevertheless, the key question is whether Asia’s exchange and system costs really are extraordinarily high: or whether the Asian sell-side is overlooking the importance of risk and liquidity in their daily decision-making.

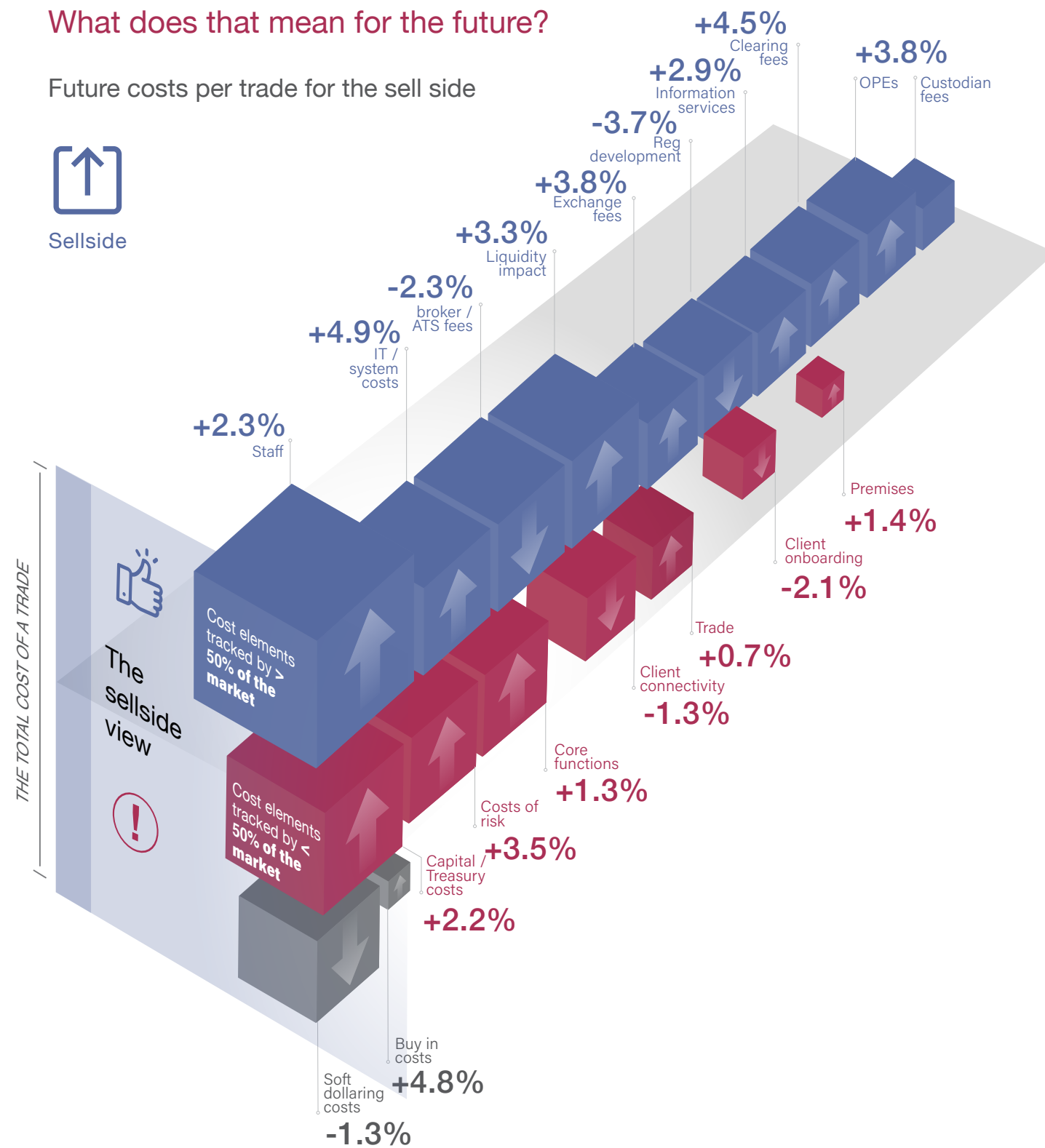
“the key question is whether Asia’s exchange and system costs really are extraordinarily high: or whether the Asian sell-side is overlooking the importance of risk and liquidity in their daily decision-making”

Regional variance in Costs per Trade



What does that mean for the future?

Future costs per trade for the sell side



Given that the global sell side expects its costs to rise (if unattended) by around 36% in the next 5 years, the central question for banks and brokers in the near future is cost containment. And you cannot contain costs that you're not tracking.

Similarly to the buy-side, the sell-side's concentrated focus on an incomplete cost base will lead to a disparity in cost-management in the coming few years. That same 50% of banks and brokers who are tracking only 62% of total costs today will, tomorrow, fail to understand a full 25% of their future cost growth – as they overlook critical growth areas such as buy-in costs (expected to grow by 5% globally and by 10% in Europe), the cost of risk (3.8% growth) and capital costs (2.2% growth).

Again, the link between transparency in costs per trade and competitive opportunity is clear here. The more diligent industry players who track these disproportionate cost increases will be able to avoid up to 25% in their cost growth by applying targeted solutions to key hot spots (by offloading the counterparties that generate the most risk, for example). Meanwhile, the majority of players who fail to identify and manage these costs risk having to charge their clients one additional basis-point in every four: putting them at a significant pricing and business disadvantage.



System automation: Global platforms in a local context

An Interview with Brian Collings, CEO of Torstone

IT and IT systems costs are at the heart of our industry’s current transformation. Our survey reveals that the combination of systems and staff costs make up 30% to 40% of brokers’ costs per trade, and so it is no surprise that system consolidation and automation are the #1 cost optimisation priority for both the buy and sell sides.

A common approach is for this consolidation to happen across national and regional boundaries, but Brian Collings, CEO of Torstone Technology outlines options for quicker wins.

The last decade has seen significant system transformation, at a local or single-market level. In Hong Kong, China-owned brokers have relied on global software platforms to support their ambitions for global growth. In Japan, an aging population has driven market participants to embrace global partners to reach increasing levels of automation. In Norway, regulators have sought the help of global providers to boost market competition.

Each of these drivers has resulted in an increase in global software platforms use in local markets,

however, it is striking that most of these systems continue to be used only in a single-market context. Despite the traditional sales pitches around global technology driving globalised and regionalised platforms, the business case for system transformation appears to be compelling enough to drive meaningful change, even at a single country level.

And so, what is that business case?

The starting point in many markets is often a near-monopoly platform provider used by local, onshore entities to connect with the local marketplace. Usually designed with domestic investors and trading in mind, these platforms tend to have evolved little over time, requiring manual workarounds for anything that sits outside of a rigid set of (static) capabilities.

In that context, the value of the global system in a local context is based around 4 pillars:

- Easy scale into new asset classes: As domestic investors increase their cross-border trading, they need their systems to scale with them easily, unconstrained by manual-work-arounds.

- Client reporting: Platforms must have the flexibility to meet customers’ and regulators’ changing (and increasingly sophisticated) reporting requirements. Technology must be capable of addressing the latest regulatory disclosure request in minutes, not days.
- Global levels of automation: Systems should remove the need for people and processes to be intrinsically linked and ensure that corporate action elections or accounting entries are free of the risk of fat-finger errors or 4-eye checks.
- Future proofing: Investors want confidence that the platform will continue to evolve in line with the needs of a global customer base by delivering consistent innovation in the face of regulatory, technological and market change.

There is also a right way to deploy these global systems locally and the scope of these local deployments is key. Replacing a broker’s global back-office system or a fund manager’s regional middle office platform requires millions of man hours of effort involving complex project deliverables across multiple markets and stakeholders. Yet replacing a local, onshore system (which serves a single, local trading entity) can be done in collaboration with a minimal number of stakeholders and with limited business disturbance. If the costs

of change are lower, then the business case is immediately more compelling, which creates a natural starting point for a transformation project.

That is not to say that global vision is totally excluded - it just remains part of the longer-term strategy. Removing barriers to regionalisation at some point in the future is an additional, valuable (but not essential) part of the business case. Transitioning to global technology platforms can drive greater standardisation of processes locally and, in turn, facilitate greater offshoring and resource balancing as part of a globalised operating model. The system doesn’t need to go global in order to help organisations act globally.

The volume of local, single-market platform change is evidence of how compelling this business case can be, as this same playbook continues to be played out in more and more markets around the world every year.

Yet in many cases we are still only scratching the surface in realising true efficiencies in single markets. So long as brokers in Hong Kong are still entering their trades manually into CCASS, or Canadian brokers are using US centric systems, the case for system transformation at a local level will continue to thrive.



- + Easy Scale into new asset classes
 - + Client reporting
 - + Global levels of automation
 - + Future proofing
- Single-market system transformation

“The volume of local, single-market platform change **is evidence of how compelling this business case can be.**”

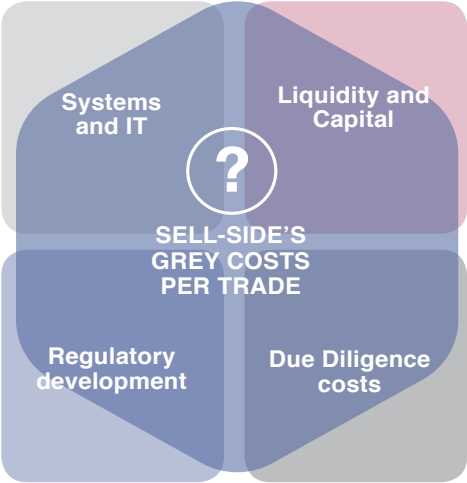


What are the grey costs of a trade?

Systems and IT: It's expensive to do business in APAC

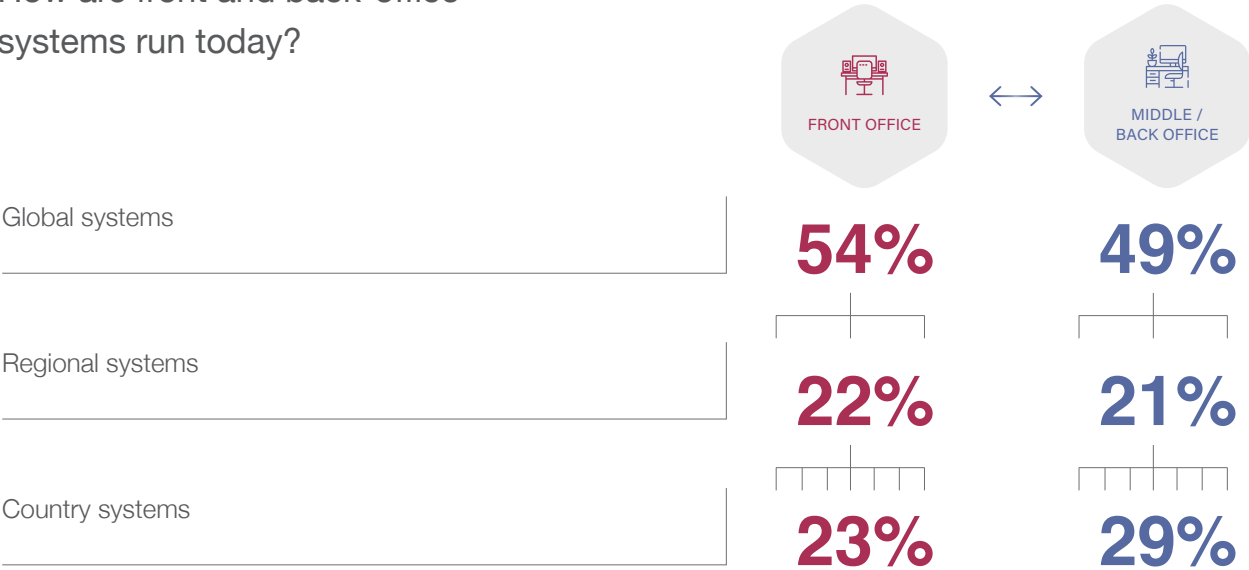
27% of APAC front office systems and 44% of APAC back office systems are single-country systems: creating obvious obstacles to scale. With local regulations in India, Taiwan and China requiring onshore systems, the Asian sell side faces an immovable cost burden in terms of systems costs – that also spills over into increasing staffing costs and costs of risk.

Equally it is extremely expensive (on an ongoing basis) to ensure that your siloed systems in Taiwan, Japan and Hong Kong are all providing the same data in the same, comparable format for example. And that cost of data management and transparency comes back into the cost of a trade.



27% of APAC front office systems and 44% of APAC back office systems are single-country systems: creating obvious obstacles to scale.

How are front and back-office systems run today?



Liquidity and capital: the new competitive edge or disqualifier

Few industry participants are today charging or paying for intraday liquidity - yet Basel regulations mean that “the costs of liquidity must be charged for.” As a transparent marketplace for intraday liquidity will inevitably begin to form, we will see a change in the provider and banking landscape.

With other product fees (such as custodian charges, etc.) now almost entirely commoditised today, bank’s treasuries will be the new source of competitive edge – playing a decisive role in reshaping relationship P&Ls and recasting many banking and custodial relationships.

For brokers, the additional costs of liquidity and the growing needs for capital (driven by IOSCO changes, UMR and other regulations) will create another existential threat. Having struggled to adapt to the shock events such as MIFID in the last decade, many smaller and mid-tier brokers will not be able to maintain the required levels of capital in order to survive, nor will they be able to invest in more sophisticated liquidity management technologies that can optimise their balance sheets and provide much-needed relief.

Today, European banks and brokers clearly understand this pressure (citing capital and liquidity as their #1 cost per trade) and are fuelling a renewed interest in outsourced clearing and other capital-efficiency measures.

Beyond the sell-side, how will fund managers react to these changes as Liquidity Risk Management and other regulations bring liquidity to the top of their agendas as well?



Regulatory Development: not always a hidden cost

The costs of regulatory development are estimated to be around 5% of the costs of a trade for banks and brokers – the 9th biggest cost and roughly on a par with data vendor-fees and exchange fees. This remarkably low figure shows how regulatory change has become ingrained in our normal operating costs.

Yet occasionally a regulation is direct and targeted – and hence highly visible. Like CSD-R (the Central Securities Depositories Regulation). Driven almost solely by this regulation, buy-in costs (currently 1% of the costs per trade for the sell side) are expected to rise by more than any other cost in the next 5 years: with European banks and brokers expecting a 10% cost increase. Regardless of when CSD-R is finally implemented, this European regulation designed to drive market efficiency will cost the sell side a great deal in the short term. The buy-side expect no change: expecting to have all of their costs absorbed by the same sell side providers who have just survived MIFID and UMR.

Due diligence costs: harming innovation?

What do Conduct, Cyber-security and Anti-slavery laws have in common? They have all triggered an exponential increase in the cost of our due diligence on our unregulated / technology service providers. Whilst Banks and brokers expect the costs of due diligence on each other to stay flat or fall over the next 3 years, they see the costs of due diligence on technology and service providers escalating by over 3%. In a world of innovation, increasing outsourcing and interdependence, the sell side is creaking under the increasingly onerous and exhaustive oversight obligations that they now carry.

This creates a resource distortion (and cost) that is not insignificant, but the major challenge here is how this impacts innovation. Given the rapidly reducing risk tolerance of regulated institutions, many smaller (technology) companies will either find themselves falling short of new risk requirements, or they will have to pass on the cost of meeting these elevated requirements back to their customers. For providers this means higher barriers to entry (and hence less innovation); and for the sell-side customers this means reduced supply of potentially innovative partners – all of which come at a higher cost to them.



Covid and the Cost of Risk



An interview with Nick Clarke of GBST

The first few months of 2020 have recast the total costs per trade equation dramatically: changing business cases overnight and reshaping our investment priorities for the future. In 2019, business evaluations were based on costs and the risk of something going wrong. Today, those risks have been supplanted by the risk of no one being able to do the task at all.

Although it is far too early to draw conclusions on the new operating model that the post-Covid world will adopt, the industry has begun acting quickly in Q2 2020 to accelerate change in key areas – and to drive meaningful risk reductions that future-proof our industry.

Nick Clarke (Head of Capital Markets Product Management at GBST) shared his views on what the new criteria are for today's cost decisions.

The end of 'body-shopping'? Almost certainly. 2020 has exposed the large difference between offshoring and automation. Our industry has realised significant cost savings in the last decade by moving processes to shared service centres in India, Malaysia, Poland and elsewhere. But challenges accessing these centres during Covid has been a

key reminder that offshoring can only yield so much. In light of having to re-onshore key processes during the crisis, many organisations are now aware that true scalability comes from automating processes as fully as possible - using APIs and intelligent workflow for standardised processes; and then machine-learning to manage a large volume of exceptions.

The end of paper? Slowly but surely. But automation can only take us so far. Many markets (in Asia and Africa); and many organisations (such as retail fund managers and brokers) continue to face highly manual, paper-based processes – which lie outside of their direct control. Cheque signatures, corporate actions and desktop-based market interfaces were enough to keep one broker in Hong Kong from releasing any more than 30% of their staff to work from home during the crisis, for example. Yet reaching higher levels of automation (and staff flexibility) would need: customers to change their behaviours (i.e. no more cheques); CSDs to revise their connectivity in many markets; and corporate issuers to adopt industry standards (e.g. in corporate action messaging) much more aggressively than ever before.

This is no quick win – but that is not to say that

“I never thought I'd have to risk my life to sign our company cheques”

progress is impossible. Whilst some authorities have won support for temporarily waiving the need for burdensome tax documentation (i.e. for physical passport copies and certificates) during the crisis, they will soon need to decide how they manage the backlog of pending requests at a time when markets in the Middle East has proven how quickly and easily these entire areas can be digitised. Will we see market authorities digitise as fast as we want and need them to?

The end of innovation? Far from it. Technologies that were once on the fringe have been thrust into consideration and are now part of conventional wisdom in no small part due to Covid. Cloud computing not only ensures employees are productive whilst working from home but can also dramatically lower core banking system costs. The business case for generational upgrades to core infrastructure has never been stronger and systems that deliver scale, whilst protecting from pandemic-sized jolts to the system and reducing costs are in contention.

“Many lessons, both human and economic will be learnt from this pandemic and **those firms that capitalise on those learnings will succeed in the long run.**”

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6. Why are we missing so much of our costs?

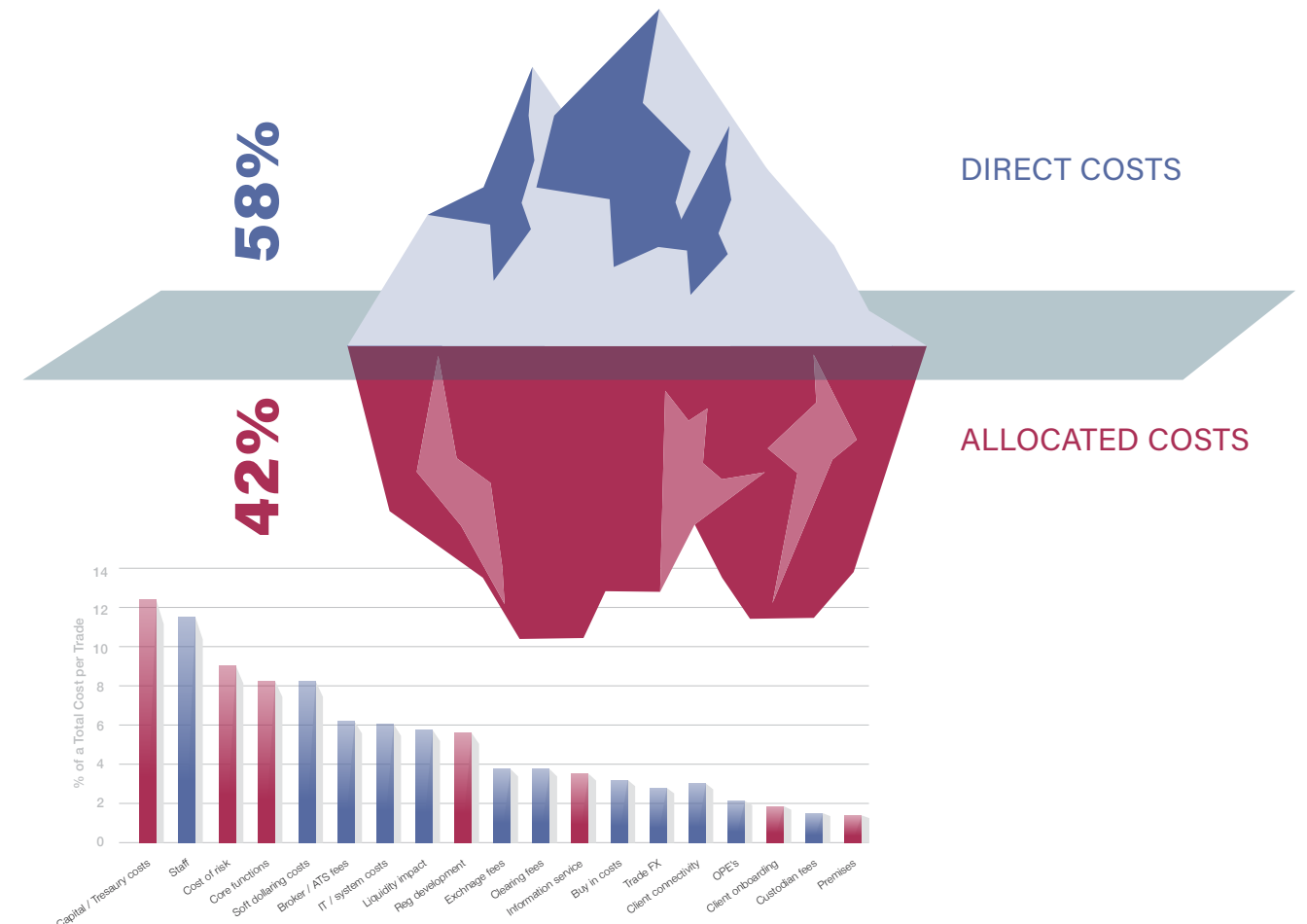
61% of the industry **lacks the access or data to track costs**

70% of us understand the importance of transparent, cost per trade data – as a source of competitive differentiation. But why then are we comfortable acknowledging that it is usual for us to oversee only 60% of our costs on average?

There are two key drivers to this problem: structural and human factors

Allocated costs: the next frontier

How can allocated costs distort our view of the cost of a trade?





Of all ‘grey’ or opaque costs of a trade, allocated costs are by far the most impactful – distorting our views of the cost of a trade by up to 42%. They are extremely hard to quantify at a per trade level (e.g. how many lawyers did it take you to execute the last trade?) and they are often outside of the control of large parts of the organisation (i.e. how many portfolio managers are allowed to decide the annual Compliance budget?).

As we have seen, the costs such as the cost of risk, the cost of capital, the cost of compliance or legal functions (the leading allocated costs that we have identified) are not only all meaningful but also growing fast: meaning that they will cast an increasing shadow over organisations’ profitability modelling and competitive planning in the future.

So how are we dealing with them today? Anecdotally we are doing everything from “excluding them entirely from our cost base” to “using crude

measures like dividing our allocated costs by our revenues” to map out future plans and cost models.

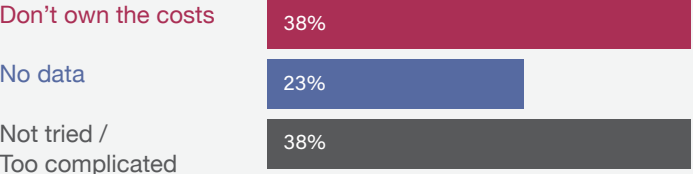
But whilst many organisations admit that the tracking of allocated costs on a per trade level is beyond them, the answer lies in transparent, top-down collaboration. “Every organisation could put five or six people in a room and crack them,” provided that they have right experience and the right motivations to define the relationship between an event and the resources required to support it.

Beyond simple teamwork, business process management (BPM) platforms have yielded significant results for some market leaders: helping them to standardise processes and derive cost transparency at a remarkably granular level.

Given the massive distortion that allocated costs can lead to, it is certainly worth the effort.

The Great organisational divide

Which organisational factors impact our visibility of a cost per trade?



Yet human factors are at play too...

At best, colleagues working in silos can be oblivious to the solutions that other departments may hold to their problems. Treasury might maintain a clear view of its costs of liquidity and capital, making every effort to optimise its efficiency in the face of new regulations. Across the corridor, Operations will no doubt be doing the same thing. But Treasury will solve liquidity issues using the options within its control: seeking cheaper bank funding instead of stopping to examine (with their Ops colleagues) whether other alternative operational models (outsourced clearing, for example) could solve their issue and reduce costs at the same time. Opportunities for efficiencies will be missed.

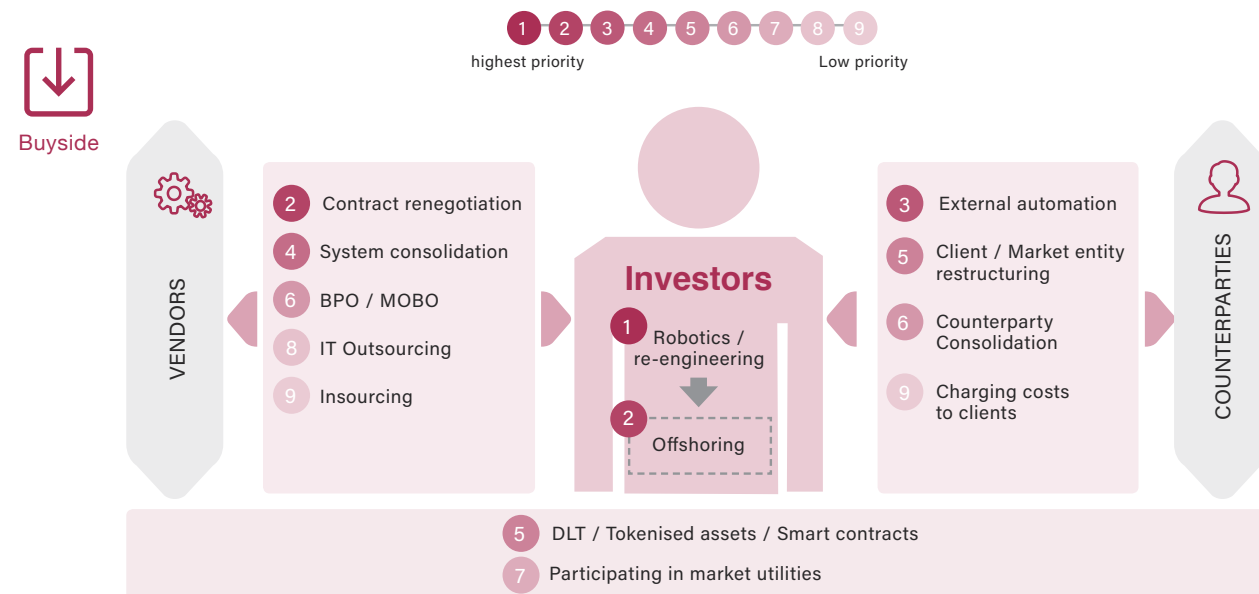
At worst, people can be an active barrier to transparency. 23% of respondents ‘lack access to the data’ they need to manage their costs per trade. Without the right levels of sponsorship, information requests can often be rebuffed or returned incomplete, for reasons of ‘sensitivity’, conflicting priorities or just lack of effort.



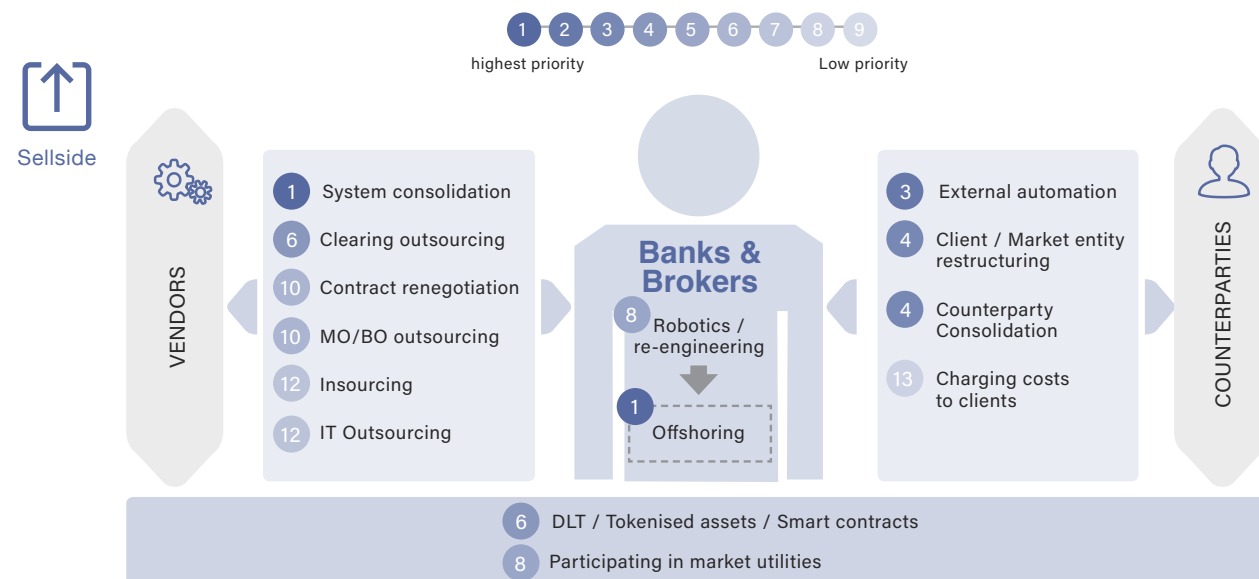


7. What are people doing to control their costs?

Consolidation and CRM 2.0



Haven't we reached a stage of diminishing returns with offshoring and robotics - versus the huge potential of DLT, AI and other technologies?



Banks and brokers expect their costs to rise by 38% in the next 5 years – whilst their investor clients expect to see a reduction of 56%. In this context, costs per trade are an existential issue. So how is our industry reacting? How are those at the vanguard of cost per trade measurement acting versus those who have little or no visibility?



System consolidation

- With 48% of front and back office systems run regionally or locally, there is a lot of automation and data transparency to be realised by consolidating systems across markets and asset classes.
- In an era of increasing M&A activity (driven, for example, by Morgan Stanley's desire to diversify; by Virtu's need to become a neo-tier 1 broker; or by Sanford Bernstein's desire to deepen its product offering), system consolidation is also a key step in realising the required synergies of these major transactions: across the buy- and sell-sides
- Yet, whilst the buy-side's platforms are already more global than those of brokers and banks, old problems still persist: regulations dictate local systems across large parts of Asia, functional offerings fail to span asset classes or regions and, most of all, few organisations have the change-management resource to deliver on large scale transitions today.



Cost cutting: diminishing returns?

- Offshoring and process automation remain priorities for many parts of our industry given that they are easy to control and deliver both cost and risk benefits
- Yet after years of effort, "are we reaching a point of diminishing returns on these cost options?" whilst others (DLT, etc.) are still only beginning to show their true worth?
- Add to this the new risks that Covid-19 has highlighted: when operations have been 'onshored' back from shared service centres for the first time in order to maintain business continuity.



CRM 2.0

- The client relationship is getting more attention than ever.
- Increased external automation is a priority shared by both the buy- and sell-sides, as is the consolidation of counterparty relationships – as market participants leverage APIs and new technologies in the quest for new efficiencies.
- On the sell-side, entity consolidation is also on the cards: leaving us with fewer, more automated and more capital-efficient relationships than ever.
- Yet the sell-side is split on how to incentivise investor-clients towards these efficiencies when needed. In Europe, brokers seem happy to pass on more costs to their clients in the drive towards transparency, whereas Asian brokers and banks see that as a worst-case option (despite it saving over 10% of costs on average).
- Perhaps one reason for the sell-side's caution is that the buy-side are showing little belief in "strategic partnership" with their vendors – in comparison with the sell side – as investors give



their partners an average score of 2.15 out of 5 for strategic value vs 2.48 on the sell side. Is the buy-side looking for more traditional, vendor relationships or is the sell-side failing to engage at a strategic level? 2020 in perspective

- And why do we need fewer relationships anyway? “Technology is an enabler that should make it easier to have more counterparties rather than less – and to minimise the complexity”



Middle and Back Office outsourcing

- Our “2020 in Perspective” survey highlighted the growing gap in outsourcing adoption between the buy-side and sell-side: driven as much by limited supply as by poor demand.
- “Investment banks want to outsource everything” but no provider is so far offering a truly cross-asset platform that would meet the market need.
- Meanwhile on the buy-side, the integrated propositions of custodian banks (as depobanks, outsourcing providers, custodians, administrators and transfer agents) means that they can deliver up to 42% in cost savings to their fund manager-clients.
- For now, those who have outsourced (in all segments) will continue to outsource more and more: aiming to avoid 14% in cost growth over the next 5 years (versus those who haven’t outsourced) by reducing their cost of risk and staff costs primarily.
- But the case isn’t black and white. Those who haven’t outsourced see themselves as more competitive on FX costs (avoiding a vendor lock-in) and more agile in selecting best-of-breed platforms that will help them meet regulatory and client needs better. No wonder that this group is leading the charge on DLT adoption.



DLT: “there are better ways to save on costs”

- Whilst we have yet to appreciate the case for DLT adoption on a market-wide scale, the business case for adopting this new technology to meet specific, niche requirements is now becoming clearer: protection for participants, improved latency of information (and funds), more automation and – in a cost context – greater transparency around costs at every step of the trading cycle.
- Yet cost transparency doesn’t immediately or directly mean cost reduction. “Our DLT deployment was about security and usability for the market – but it’s difficult to see us realising cost savings from this initiative”.
- Key within these costs are the market costs of delivery. In Australia, where the ASX’s replacement of CHESS leads the world as a DLT initiative, many brokers have claimed that they have had to “put all market-linked projects on hold, until the ASX project deliverables are clearer”.

Read more about why, how and where our industry is adopting DLT - in our “DLT in the Real World” industry survey [available at [thevalueexchange.co/dltintherealworld](https://www.thevalueexchange.co/dltintherealworld)]



Where there’s a will....?

- The continuing challenge in realising change however is not the business case or the value of the market solutions: it is the cost of change
- “The appetite to do the work far exceeds the budget pools available” in most organisations: creating a potential jaw-effect in the industry as larger organisations invest heavily and reap the exponential rewards from transformation; whilst smaller organisations remain rooted in the present, unable to invest and hence unable to build a future-proof P&L.
- Equally budgets and needs do not always align. Insurance-owned fund managers have a natural advantage here - being able to draw on significant pools of capital to fuel long-term, deep-rooted transformation projects. One such fund manager has spent over USD200m (in the last 5 years) to deploy a new target operating model. Few other investors could deploy such capital today.

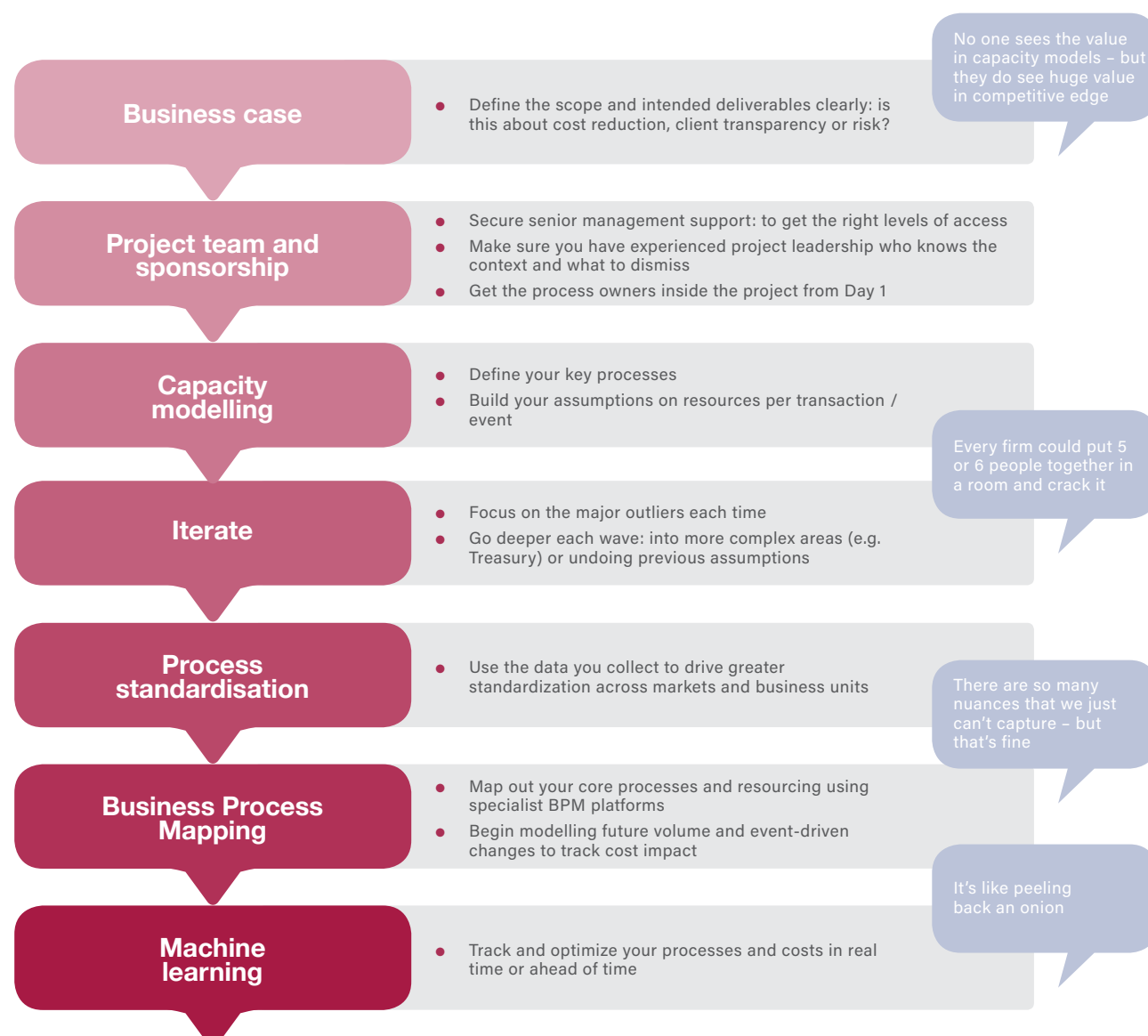


So what do we do now?

Managing Total costs per trade: Industry Best Practice

We are all at different stages of our evolution in tracking and managing our costs per trade – and so what have we learned as an industry so far?

The Process



The Core Principles:

- 1 It's all about driving the conversation: Cost per trade analysis quickly becomes an art – not a science. The key is to not to map the world but rather to identify key action areas – often one at a time.**
- 2 'It's all relative – it's never absolute': Countless organisational specifics mean that cost per trade data rarely scales outside of a specific context. The data's value is relative to other units, processes or time.**
- 3 It's a discipline – not an event: There are many waves, going deeper each time as expertise and transparency grows. And of course the data must be kept up to date.**

Thank you!

This campaign has been a truly industry-wide initiative, bringing together expertise from every sector and geography to help shape a new industry best-practice. We are very grateful for the support of GBST, Torstone, the Jersey Company, the Trade, The Network Forum and our expert contributors whose insights have shaped this report.

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