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Mutual interest

SmartStream's Philippe Chambadal explains why cooperation is the new paradigm for the banking industry

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Let's work together

Philippe Chambadal, CEO, SmartStream, tells FX-MM editor Peter Garnham why banks need to overhaul their business models and embrace utilities to prosper in the post-financial-crisis world.

There needs to be a sea-change across the investment banking industry or some firms will find it increasingly hard to survive, according to Chambadal.

The reason is simple: since the financial crisis, revenues have fallen dramatically, while costs have at best held steady. It is those costs that need to be addressed, and part of the answer, says Chambadal, is a shift towards mutualising them and the widespread adoption of utility models.

Indeed, in the post-trade world, any process that does not give a bank a competitive edge, is ripe for a move to a utility model, he says.

"When a bank has 30, 40, 50 thousand people employed in its back office, it has to ask itself if there is a better way of doing business," says Chambadal. "What the crisis has proven is that operating costs are far too high, and the only way forward is to move them outside to a mutualised model."

He is not alone in that thinking. Boston Consulting Group's, (BCG), Capital Markets Report estimates that bank capital markets revenues dropped from $374 billion in 2009 to $244 billion in 2015.

A staggering $100 billion in annual revenue has, therefore, been lost in the industry as a result of the prolonged period of depressed global interest rates, which has dampened volatility, suppressed trade activity, compressed spreads and narrowed net interest margins. Costs, in contrast, remain "stubbornly high", according to BCG, leaving industry operating profits at historic lows.

BCG says this problem needs a transformative approach, with all firms needing to take "drastic action" on the cost side, exploring which activities are not differentiated and considering utilities, shared services and agreements to mutualise costs.

A new paradigm

Chambadal concurs: "To lose $100 billion in revenues is a massive drop. The problem is that instead of banks having costs under control, they either stayed flat or increased, so they are in a real bind."

He says, therefore, that banks need to re-think and re-tool their business models in order to survive.

"If they don't re-tool, they will lose their competitive edge, it's as simple as that," says Chambadal. "When you have such a drop in your top line and costs don't move, then you really have to change your ways."

In the post-trade world, Chambadal estimates that banks waste between $50 billion to $65 billion a year due to the inadequacies of their processing systems. This is because there is no straight-through-processing, with the result that banks are inundated by broken trades, broken payments, broken corporate actions and broken reference data – that need to be repaired, often at great cost by hand.

It is not just cost pressures that are driving banks to re-engineer their post-trade processes, however. Regulators are pushing for an intra-day, real time view of banks' operations – into the flow of payments and trades. They want transparency in the financial system. That means that banks are being forced to move from batch processing systems, which give intermittent views of their activity, to ones which give a real-time view of their operations.

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The case for change

These cost and regulatory pressures go hand in hand, according to Chambadal, in driving the need for change in bank post-trade processing. As he notes, the driver of Mifid II in Europe was a desire from regulators for banks to be more competitive.

"Everyone wants to restore trust in the financial system, in the banks, and part of that is a big push for better governance throughout and greater transparency throughout organisations, so banks have control over their operational risk and their market risk," says Chambadal.

In the end, says Chambadal, cost and regulatory pressures combine to make the case for moving post-trade processes to a shared model compelling.

"If a bank wants to move from a batch system to a real-time system, it can spend hundreds of millions dollars to do it itself or it can move to a utility," he says. "With a utility it can make the move in a matter of a few weeks or a few months, instead of doing it itself and taking two or three years. And it costs 10 to 20 times more to try and do it itself. It is an easy decision."

Re-tooling those systems in-house is, says Chambadal, simply too expensive for banks and takes too long.

A radical approach

That was a conclusion that SmartStream came to five years ago, according to Chambadal, when it decided to re-write the code that drives its systems – for everything from reconciliations, cash management and liquidity management to reference data and fees management – to operate as a mutualised service.

"We built all these different products on a common framework that is multi-tenanted and designed from the get-go as a utility. That was really different and radical," he says.

"If you are designing a piece of code that serves one bank versus a piece of code that serves 500 banks, the design is radically different. So we made the investment and other software vendors didn't. They remained in the one-to-one world, as we moved swiftly to the utility model."

That decision has turned out to be prescient as banks came to the same conclusion over post-trade services, recognising that there was no competitive advantage to be had from running systems in-house. After all, as Chambadal notes, you are only as good as your counterparty's systems.

"Two or three years ago, the most advanced banks in terms of strategy and sophistication of their IT operations all came to the same conclusion: that trying to build the systems themselves was not the way forward," he says. "They started to call each other."

Collaboration in action

A prime example of this new mood of collaboration and SmartStream's foresight was the launch last year of Reference Data Services LLC. A joint venture with Goldman Sachs, JP Morgan Chase, Morgan Stanley and Smartstream, it is an industry-led service using the SmartStream Reference Data Utility.

"Our utility is proven, and has been in production for five years. That is one of the reason – as well as the design – that our system was chosen," says Chambadal. "Our competition had nothing in production; our technology design and production experience made all the difference."

Using the utility guarantees that participants are using the same reference data as their counterparts and helps avoid trade breaks due to mismatches.

The potential cost savings from the reference data utility are striking. Large sell-side banks typically spend between $50 million to $100 million a year on reference data. As Chambadal notes, SmartStream can do it once for the entire industry.

As well as mutualising that cost, there are downstream benefits from the reference data utility as the ripple effect of bad reference data in the industry is huge. Chambadal estimates that about 30% to 40% of the waste in post-trade caused by broken trades is due to bad reference data – equivalent to at least $15 billion a year wasted. He says the reference data utility can not only reduce clients' direct EDM costs by 30% to 50%, but also eliminate 80% to 90% of trade breaks due to reference data mismatches. It can, in other words, save clients tens of millions of dollars within 12 months.

In addition, the more institutions that join the utility, the greater the benefits are for all.

"That is the beauty of a utility," says Chambadal. "If a client identifies a problem, other banks and their clients get the benefit immediately. The more users you have, the more feedback you receive, and the better data you are going to have for everybody."

While cost saving is paramount, there is a further benefit for banks from the reference data utility as they bring their clients on board, according to Chambadal.

"Banks want to use it for themselves, to reduce costs, but they also want their clients to use the same data model and high quality as them so they can eliminate the trade breaks that create friction in their relationships," he says. "That is a very important part of the plan: to share a high quality data model between the buy-side and the sell-side."

SmartStream has also established a BC&E fees management utility and a reconciliations utility, both of which are delivering value for clients, according to Chambadal and enabling banks to achieve greater levels of efficiency through straight through processing and automation.

Competitive advantage

Chambadal says utilities have the ability to drop the bar in terms of the cost of processing trades to banks. He cites the example of a client which saw its cost per trade drop from 28 cents to just a couple of cents after creating a SmartStream based post-trade COE.

"When you have that level of efficiency, other players have to look seriously and ask how their competitor got there," he says. "That is because as operational costs drop, the costs charged back to the client are so much lower and margins get so much better. Banks have to react quickly so they are not at a competitive disadvantage."

Chambadal says sell-side banks should look to the buy-side, such as fund managers and corporates, for inspiration. After all, they have long since hived off their back office operations to the likes of custodians such as Bank of New York Mellon, State Street and Northern Trust.

"For the last 15 years, the buy-side has done everything to get rid of everything in-house – they don't want to run a database, an exchange server or a corporate treasury management system," he says. "Our argument is that the same thing has to happen to the sell-side."

He believes that instead of farming out the whole back office, due to the complexity of sell-side banks, it will happen one service at a time.

"It might take three or five years. The complexity of the sell-side is an order of magnitude greater than the buy-side," says Chambadal. "A large sell-side is going to run 1,000 applications, so mutualisation and externalisation is much easier to do one service at a time. But it is happening, and it is happening before our eyes."

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Seeing the light

The financial crisis has therefore created a new model for banking that is transforming the industry radically, according to Chambadal.

"The head of operations at every bank has seen the light. The only way forward is mutualisation, and they are looking for vendors to help them get there," he says. "The days of banks trying to fix the problems in their back offices processes for themselves are gone. Because it is irrelevant, banks can spend billions of dollars to be the best in the world, and for what? You are only as good as your counterparty."

Ultimately, that leaves banks to play to their strengths, creating a stronger industry.

"Banks should be banking: they should service their clients and invest their money, that is what they do," says Chambadal.

"Repairing broken trades is not part of their DNA, and it is not where they make money. That is what the financial crisis has proven: that bank operating costs are far too high and the only way forward is to move them outside to a mutualised model."

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