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Market utilities in financial services

What role will you play?

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Executive summary

With increasing frequency, companies in the financial-services industry are pooling resources, expertise, and capabilities to create market utilities focused on specific functions such as client services and on-boarding, trading and execution, and cash and collateral management. We define a market utility as follows: a multiparty commercial cooperative that fulfills a common need in a mutually beneficial way based on the capabilities that each party brings to the cooperative and the role that each plays.

More than 40 market utilities have been founded in the financial-services industry over the past several years, and in some cases multiple utilities have sprung up to perform the same function — for example, trading and execution, or data management. Many of our clients have pondered whether the formation of these utilities is a fad, and if not, whether they need to participate and in what capacity. It is our opinion that market utilities are going to be a permanent fixture in the industry. The formation of cooperative functions is a necessary response to the massive structural changes — regulatory as well as macroeconomic — that are sweeping the industry and creating a common set of needs in areas such as liquidity, compliance, and data sharing. Companies can tackle these needs more efficiently if they work as part of a consortium rather than on their own.

Therefore, it is critical for industry participants to decide which market utilities they will participate in and what roles they will play. Should they team up with others to start and control their own utility? Should they join an existing utility with the idea of exerting some influence over its direction? Should they collaborate by offering expertise to a utility without concern for exerting control? Or should they simply use the facility and not worry about contributing capabilities or controlling its direction? For each organization, the answer will depend on the utility's function, the level of control the company wants to exert, and the capabilities it will bring to the table.

We believe that in the near future, most financial-services industry firms will play different roles in several market utilities, and will thus need to manage a "portfolio" of market utilities in which they participate. With this in mind, we have developed a series of screening questions for executives to consider to determine if a particular activity done in-house is better suited to a utility and, if so, what role the organization should play in that utility.

Market utilities are here to stay

In the last several years, more than 40 “market utilities” have been created in the financial-services industry — often involving competitors — to perform some common function in the front, middle, or back office. The utilities are taking care of everything from client services and on-boarding to cash and collateral management to asset servicing and custody. In fact, the formation of these market utilities has been so fast and furious that multiple competing utilities have sprung up for some functions and are jockeying for members.

Firms are finding that these cooperative entities work to their advantage in ways that are critical to success in today’s markets. Utilities help participants gain power and control so that they can limit monopolistic vendors and increase their own market liquidity, as well as conduct a secure collaboration to achieve common goals, and improve their access to scale (*see Exhibit 1, next page*).

On the surface, market utilities might look like just another experiment in cost cutting, but we believe they are here to stay. Although these cooperative arrangements do offer a massive opportunity for cost savings, they differ from the internal shared-services model, which is focused on coordinating and leveraging internal resources to lower costs. Rather, market utilities are a relatively new way to solve common industry needs in areas such as liquidity, compliance, and data sharing through cooperation among multiple industry participants, thus achieving a level of scale and efficiency unattainable by any single player.

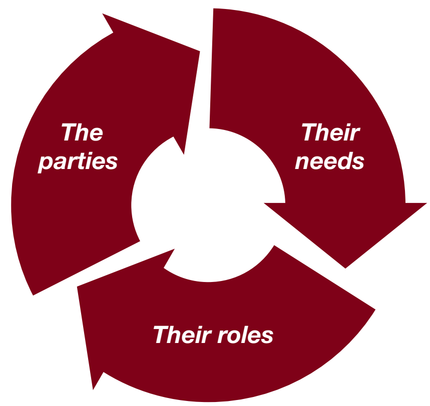
Given this backdrop, we believe now is the time for industry participants to decide which market utilities they will participate in and what roles they will play. To position their firms correctly, executives need to carefully assess their operations, decide which functions within the organization might be better suited to a market utility, and then decide how the organization should participate in that utility.

Exhibit 1
How we think about market utilities

Market utilities are multiple-party commercial constructs (cooperatives) that fulfill a common need for many industry participants in a mutually beneficial way

Multiple parties form commercial constructs . . .

- **Industry participants** on the buy and sell sides interact in capital markets (e.g., asset managers, investment banks, brokers/dealers, custodians)
- **Infrastructure providers** act as facilitators to connect participants (e.g., exchanges, CCPs, CSDs)
- **BPO service providers** use expertise in commercialization to bring scale to the industry
- **Technology vendors** provide intellectual capital and technology, and act as drivers of innovation



. . . that fulfill a common need for many participants . . .

- Can give **power and control** to industry participants (e.g., allowing them to limit a monopolistic vendor or to increase market liquidity)
- Allow for **secure collaboration** among industry participants to achieve common goals such as tackling common regulatory requirements, creating common standards, reducing net transactions, and sharing information
- Improve **access to scale** by externalizing leading processes and technology to the industry as a whole

. . . in a mutually beneficial way

- The **role a particular party will play** will depend on the need being addressed, core capabilities required, and desired level of control

A sustainably successful market utility must align parties' needs, capabilities, and roles

Source: Strategy& research

Structural changes

The confluence of several structural changes in the industry is affecting all participants in the capital markets and driving the trend toward market utilities. First, expanding regulations are significantly increasing operational, technological, and data requirements. In particular, financial institutions all face similar demands for regulatory compliance and capital-to-debt ratios under the Dodd-Frank Act stress testing (DFAST) requirement, which assesses whether institutions have sufficient capital to absorb losses and support operations during adverse economic conditions, and the Basel III accord, a comprehensive set of reform measures developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision, and risk management of the banking sector. Supporting these new requirements involves expensive fixed-cost upgrades. On top of this, tougher capital requirements have decreased return on equity (ROE) for the sell side. For the most part, the investment banks, commercial banks, and research firms that make up the sell side have been unable to compensate for the lower returns, even with traditional cost cutting.

But not all changes and challenges are regulatory. Macroeconomic dynamics created by a low interest rate environment depressed certain capital-intensive businesses such as securities finance and prime brokerage. Also, the commoditization of many products and services through indexes and automated trading services has reduced pricing power and compressed margins. As a result, the investors and asset managers on the buy side are demanding more consistent and standardized products from the sell side, as well as better information to glean profitable insights about their customers. To meet shareholder expectations, industry participants need to make some fundamental, sustainable changes to the cost structure across the value chain.

Finally, in terms of structural changes, companies continue to break down silos within their organizations to better leverage resources across the entire enterprise, lower costs, and thus improve the shared-services model. But these efforts are not sufficient to absorb expensive fixed-cost upgrades associated with today's regulatory and macroeconomic environment, and to keep up with the rapid pace of technology innovation. Market utilities are seen as a solution, as a way to “externalize” and “mutualize” the cost structure across a greater swath of the value chain by partnering with other organizations in the industry to share capabilities and costs.

For example, some 42 financial institutions, including Morgan Stanley, Wells Fargo, ING, and Nasdaq, have formed a market utility led by the blockchain technology firm R3CEV. The global consortium of banks will work on a framework for using blockchain technology within financial services. This is the first time banks have collaborated on how the technology that underpins bitcoin, a Web-based “cryptocurrency,” can be used in finance. The consortium includes JPMorgan, a notable development in the rise of utilities, given that CEO Jamie Dimon has long been a proponent of keeping functions in-house.

The players involved

Market utilities can involve four types of players. Not every market utility includes all four, but most involve two or three of the following:

Industry participants such as asset managers, investment banks, broker/dealers, and custodians. These are the ultimate owners of business processes and skill sets. They create internal shared services to optimize the operating model and provide white-label solutions to others.

Infrastructure providers such as exchanges, trading platforms, central securities depositories (CSDs), and central counterparty clearinghouses (CCPs). These act as facilitators that connect participants using their scale. Given their historical role as neutral parties, they often take a leading role in the utility.

Business process outsourcing (BPO) service providers. These are experts in developing standardized, efficient processes. They assist in the commercialization of operations and help to bring scale to the industry. They include companies such as Accenture, FIS, iGate, and Wipro.

Technology vendors provide intellectual capital and technology expertise to develop external shared services, utilities, and BPOs. They improve efficiency and drive innovation.

The common needs met

Achieving scale and lowering costs are usually at the heart of a utility project. But there are other common problems that these utilities address — such as limiting the power of a supplier, increasing market liquidity, and creating common standards — that factor into the decision about whether to join a utility.

The reason that competitors can come together successfully in today's environment — more so than ever before — is that the structural changes sweeping the industry are creating common needs that must be addressed quickly to remain in compliance and competitive (*see Exhibit 2, next page*). If there were big differences in what competitors needed, there would be little incentive to work together.

The roles they play

Each member of the utility has a specific role to play based on its capabilities and needs, and a proper division of roles is critical to the formation and sustainability of a utility.

Founders: These members take a "thought leadership" role. They have a core capability necessary to the utility, and they need significant control over the utility's development and direction. This role involves large up-front investment and execution risk — including reputational damage if the market utility falters.

Joiners: These players step in to support an active consortium. These members don't have the same core capability as the founders, but they do want some control over the utility's development and direction. This role allows organizations to work closely with others in the industry, involves less risk than being a founder, yet still offers sizable upside potential if the utility is a success. That said, there is some up-front investment and execution risk.

Collaborators: These third-party service providers offer services to established consortiums. These members have a core capability necessary to the utility, but they do not need the same level of control as the founders. They have little financial and operational risk, and their involvement is a revenue opportunity.

Users: These organizations simply use the market utility without active influence in the consortium. They have neither the core capabilities at the heart of the utility, nor the need to control its development. Benefits include leveraging market standardization and enhancing risk management. But these members risk losing flexibility in client negotiations. They also have no influence over the utility's agenda.

Exhibit 2
Key needs addressed by utilities

Need of market participant	Description	Examples of utilities
Limit supplier power	Participants collaborate to create a self-owned alternative to a powerful supplier	– Symphony Communication Services/ Perzo (messaging service to replace Bloomberg)
Increase market liquidity	Participants collaborate to gain additional transparency of market supply/demand	– Project Neptune – Plato Partnership – Luminex Trading
Tackle common regulatory reqs	Participants collaborate or use infrastructure to tackle common operational challenges	– Margin Transit Utility/ Collateral Management Utility – Blaze
Create common standards	Infrastructure develops common industry standards leveraging input from participants	– Swift – Omgeo SSI – BT SettleNet
Reduce/net transactions	Infrastructure acts as a middleman between participants to minimize handoffs	– DTC – Euroclear – DTCC Deriv/SERV – LSE's CSD
Share data	Infrastructure or BPOs help participants collaborate to enable secure data sharing	– Clarient Entity Hub – Markit/Genpact KYC – Swift KYC Registry – Soltra Edge (cybersecurity)
Recoup startup cost	BPOs externalize participants' in-house solutions for industry use to recoup setup cost	– FIS/Crédit Agricole derivative platform – SunGard's post-trade derivatives utility
Ability to purchase scale	BPOs and technology vendors jointly create comprehensive software/services	– Accenture Post-Trade Processing service – Wipro/LSE reconciliation utility

Source: Industry news; Strategy& analysis

Which activities are right for a utility?

With market utilities addressing more and more components of the value chain, executive teams need a set of criteria to determine which current functions are candidates for moving to a utility. Cost savings are an important consideration; however, a decision based solely on anticipated cost savings may ultimately disappoint. The decision about whether to participate in a utility should be grounded in the organization's competitive strategy.

To identify the functions within the enterprise that might be better suited to a utility, we have developed several questions that an executive team should consider about internal functions.

Does the activity create a competitive advantage? If the answer to this question is yes — meaning that the executive team believes that the activity is differentiating for the organization and creates a true competitive advantage — then the organization should probably keep the function in-house and not participate in a utility. If the answer is no — meaning the activity is non-differentiating and can be shared without a loss of competitive advantage — then the activity is suited to a utility.

Does the activity address a common need of many industry participants? If the answer is yes, then the activity is suited for a utility; the high demand for a common solution is likely to promote collaboration and engagement. If the answer is no, or if a common solution could create disagreement and rivalry, then the activity is better suited to an internal shared service.

Does the activity have critical mass or global reach across many industry participants? Here again, if the answer is yes, then the function is suitable for a utility; the critical mass/global reach will encourage quick adoption and thus more rapid economic benefits. If the answer is no, or if a lack of scale or global reach would distort the economic value proposition, then the activity is better addressed by a technology solution or internal shared service.

Does the activity meet the common need in a mutually agreed-upon way? If the answer is yes, then a utility is appropriate. By agreeing on a standardized solution, individual players aren't inclined to customize their own solutions. If the answer is no, and this lack of agreement among individual players would lead to customization, then the activity is better served by outsourcing providers.

Is the need met by a combination of capabilities that can be provided by collaboration? Once again, if the answer is yes, then the function is a candidate for a utility. There is a powerful incentive for players to cooperate if they recognize that cooperation will result in a solution superior to any individual solution. But if the answer is no, or if a single industry player could offer its own solution, then the activity is better served by an outsourcing provider.

What role should you play?

Once an executive team has decided to move a certain function to a utility, it must determine the appropriate role to play in that utility. As noted earlier, as these utilities become more prevalent we anticipate that organizations will become involved in multiple utilities, and have differing roles in them depending on how each utility's activity relates to each firm's business strategy.

To determine the right role for a specific utility, executives should ask themselves two questions. The first is, "Do you have unique requirements from the utility?" If, for example, the activity is core to the organization's offering or market position, or if the organization has specific/changing customer requirements, then the organization needs a high level of control over the utility. But if the activity is a supporting function or a third-party service, or there are no specific client requirements, then the organization could accept a low level of control.

The second question is, "Do you contribute a unique capability to the utility?" If the organization owns a proprietary process or technology, or can facilitate collaboration, or has a particular expertise in building scale, then the answer to this question is yes and a high level of contribution to the utility is necessary. If, on the other hand, the organization would rather pay to leverage others' capabilities and gain access to scale, then a low level of contribution is adequate.

By plugging the yes and no answers to these questions into our utilities participation matrix, an organization can determine its optimal role. For example, if it answered yes to both questions — that it needs a high level of control and a high level of contribution — then it should become a founder of the utility. If, on the other hand, it requires a low level of control but contributes a unique capability, then it should become a collaborator (*see Exhibit 3, next page*).

Exhibit 3
Utilities participation matrix

Unique output?	Unique capability?	Role
Yes *High level of control*	**Yes** *High level of contribution*	**Founder**
Yes *High level of control*	**No** *Low level of contribution*	**Joiner**
No *Low level of control*	**Yes** *High level of contribution*	**Collaborator**
No *Low level of control*	**No** *Low level of contribution*	**User**

Source: Strategy& analysis

State of the utilities landscape

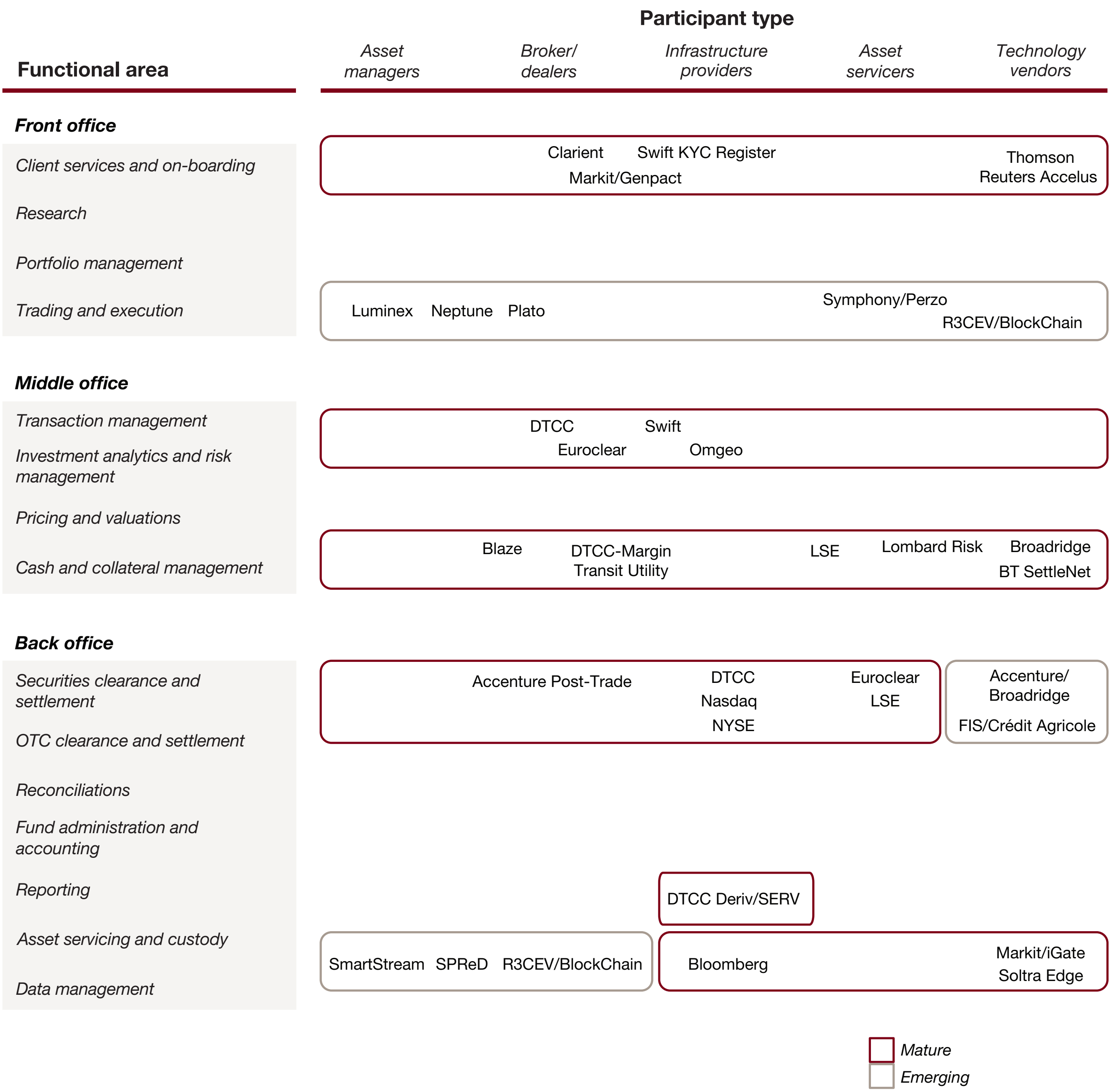
Based on our analysis of the current utilities landscape, we have identified areas where collaboration is mature, areas where collaboration is emerging, and areas where it is highly undeveloped (*see Exhibit 4, next page*).

So far, most utility development has occurred on the sell side, with mature (and sometimes multiple) utilities established across the trade life cycle. In these areas, there are few remaining opportunities to become founders. New players will most likely need to participate as users.

Emerging areas for utilities include trading, OTC clearance and settlement, asset servicing and custody, and data management. In these areas, there are still opportunities for picking roles based on control and contribution considerations. For example, an asset manager interested in participating in a trading and execution utility might look to join other asset managers and broker dealers in new utilities such as the fixed income trading platform Project Neptune and the equities trading consortium Plato Partnership.

Buy-side players should take note of the sell-side success over the last few years. If these utilities lead to increased supplier power, the buy side might need to regain control by forming its own utilities in the undeveloped areas of the market. It is this true white space where the greatest future opportunity for innovation and leadership lies.

Exhibit 4
Financial-services industry utilities landscape



Source: Industry news; Strategy& analysis

Conclusion: Managing a utility portfolio

Market utilities have been heralded by some as the solution to the industry's stagnant ROE, providing a level of scale and efficiency unachievable by any single participant's transformational efforts. However, although we believe utilities offer a massive opportunity for cost savings, they should not be thought of solely as an extension of the shared-services model. Rather, they are an opportunity to address common industry needs through cooperation and capability sharing.

As the market utility landscape develops, firms must carefully consider their own roles given the utility's purpose, the capabilities required to make the utility successful, and the level of control necessary for the firm to execute on its own strategy. As more of the value chain comes into play and more utilities are formed, executives will need to manage a portfolio of utilities and strike the right balance of roles based on business priorities and resources.

Additional resource

"Share and share alike: Meeting compliance needs together with a KYC utility." A study of utilities set up to meet anti–money laundering "know your customer" regulations. PwC, 2015. pwc.com/us/en/financial-services/publications/know-your-customer.html

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