FINDING BALANCE

THE POST-COVID LANDSCAPE FOR FINANCIAL INSTITUTIONS

Financial Infrastructure

Part 5

Resilience
Recovery
Renewal

OVERVIEW

Welcome to our fifth briefing on how COVID-19 is affecting financial institutions and its impact on current industry trends. In this edition, we focus on financial infrastructure providers (FIPs), which, as with the other subsectors discussed in this series, has seen COVID-19 accelerate existing industry trends. As always, in addition to sharing our own opinions, we reference the views of external commentators. Please bear in mind that our opinions are based on hypotheses that may change in a rapidly developing situation and there are doubtless other perspectives.

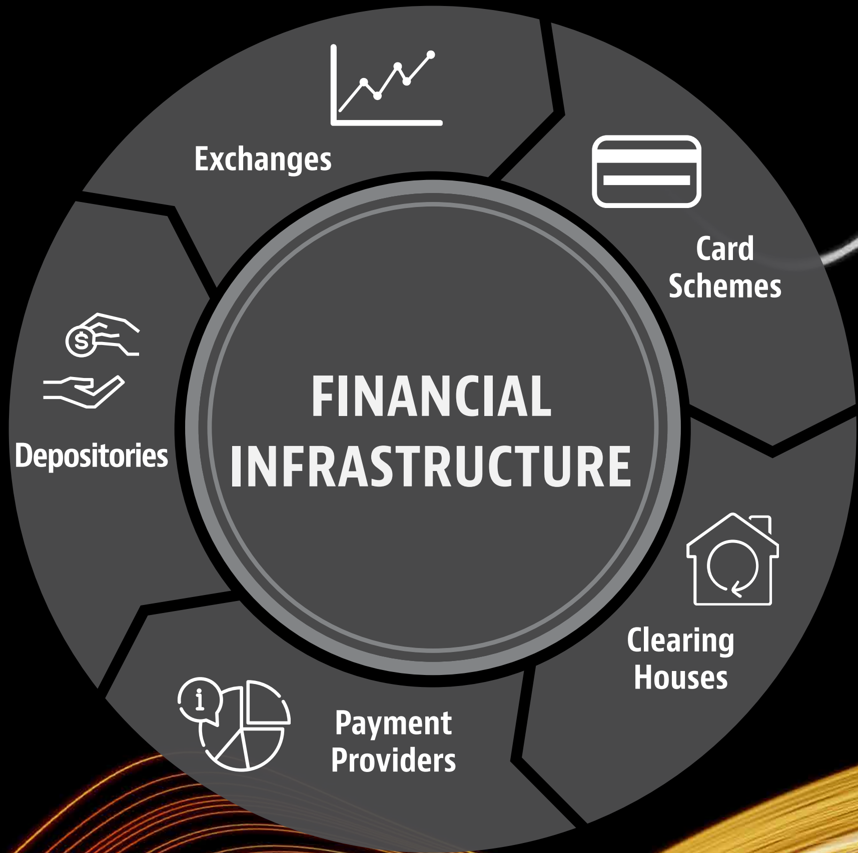
Financial institutions rely upon market infrastructure to ensure the provision of financial services. While this subsector is very diverse, for the purposes of this briefing, we will focus on FIPs such as exchanges, clearers and depositaries, as well as payment providers and systems. To date, the subsector has shown itself to be resilient in light of the stresses from COVID-19. Over recent years, it has been highly acquisitive with increasing levels of leverage resulting from in-market consolidation or growing ancillary business lines.[1] Digitalization and fintech are also transforming business models. Big Tech is investing heavily in payment products in partnership with established payment firms and in emerging market economies with less tradition of banking.[2]

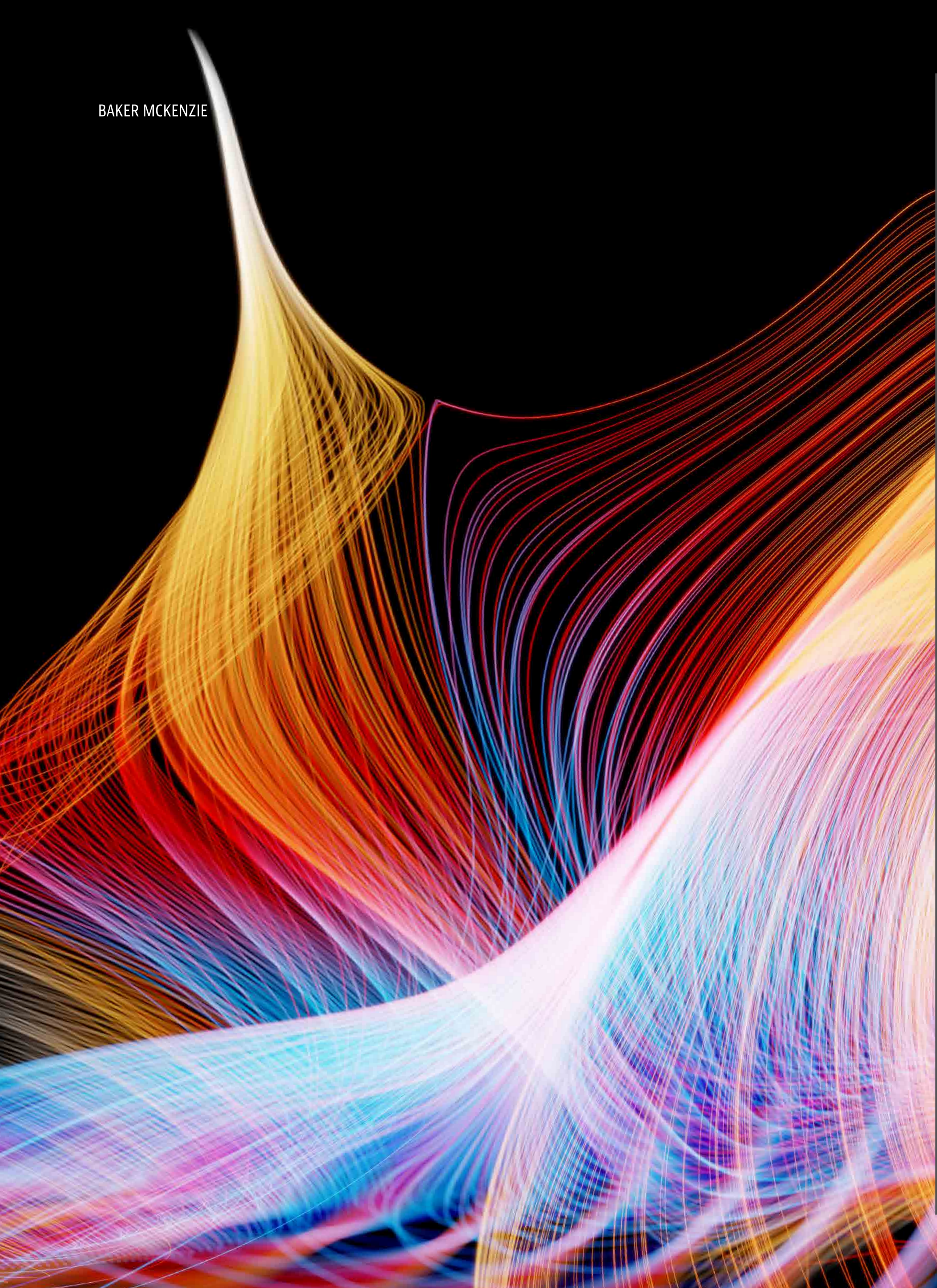
Key takeaways

- FIPs have experienced growth and profitability above average compared to most other financial institutions over the last decade. While this has been impacted by the COVID-19 crisis in 2020, it is likely to resume in the future although at a more moderate pace — especially as competition increases. The considerable degree of M&A activity around consolidation and mergers is likely to continue as institutions seek to boost profitability through scale and by increasing their presence across the value chain, although the era of the largest consolidations is now probably over due to competition and concentration fears.

- The impact of digitalization was already making its mark on the sector. In common with all financial institutions, this trend has received added impetus because of COVID-19, perhaps most markedly in the payments sphere where customer reticence to new technology has markedly reduced, for example, with cash payments declining further, and in the wholesale market, with corporates expecting additional value-added services. FIPs make up one of the most innovative sectors of the economy with the biggest institutions as information businesses beginning to resemble Big Tech providers, while its ecosystems contain many fintech and specialist providers delivering new solutions in innovative ways.

- Operational resilience is a key industry concern, especially in a subsector where operational failure is likely to affect financial stability and the orderly working of markets. Overall, FIPs have performed well during the crisis but not without incident. Regulatory scrutiny continues to increase, particularly in the area of cloud outsourcing, with supervisors imposing new requirements to mitigate risk. While it is possible to talk of the regulatory burden on FIPs, the makeup of the industry that we see today with new entrants and new solutions in the market are, in large part, a product of the regulatory reforms of the last decade and a half. This relationship is likely to continue.





Setting the scene — an industry transformed

Until recently, the subsector was viewed as a sleepy backwater compared to other financial market players. It was frequently characterized by mutually (and often nationally) owned institutions that enjoyed near or quasi-monopolies. With increasing momentum after the 2008 financial crisis, we have witnessed a transformation. FIPs have become intensively competitive information data businesses experiencing a wave of market consolidation, expansion and diversification across their value chain. Typical groups now include a range of trading platforms and clearers, through to related information services and post-trade and risk management services. Similarly, the world of payments has come to epitomize fintech with new services and competition. Banks and traditional wire transfer services have been joined by a plethora of agile tech-savvy virtual banks, e-money institutions, online payment systems, payment initiation services and outsourced payment processors. The sector has been subject to a rising tide of regulation and regulatory scrutiny, largely over concerns around financial stability, with legislation such as the US Dodd-Frank Act and the European Market Infrastructure Regulation seeking to mitigate counterparty risk, but also and particularly in the payments sphere, to protect customers and to boost competition, for example, by facilitating new third-party service provider freedoms.

COVID-19 — the immediate impact

The crisis has seen significant demands placed on market infrastructure, whether it be trading venues, clearing or payment systems. The initial stages of the pandemic in the first half of 2020 saw a period of significant volatility on financial markets with record volumes of trading. Equity, debt and oil markets were, at one stage, in free fall with money and repo markets under tremendous stress.[3] While global central bank intervention ultimately stabilized markets, strengthened risk management and operational resilience largely ensured that they continued to function well — instances are infrequent in March 2020 of exchanges taking systems offline where maximum tolerance levels were triggered.[4] In the payments sphere, for payment providers and card schemes, lockdowns resulted, briefly, in a near collapse of both retail and business expenditure, most notably in the hospitality and travel sectors interrupting what had been a long period of revenue growth. Overall, consumer spending has now largely bounced back. With stay-at-home restrictions, e-commerce has received a significant boost and the trend to cashless payments has been reinforced, particularly in older customer age groups. Overall, therefore, some models suggest that global payment revenues will increase from about 1% to 3% depending on the nature of the economic recovery — this would represent half the rate of growth over the last five years. Nonetheless, the prospects for the medium and long term are good.[5]

RIVAL FINANCIAL CENTERS

There is tremendous competition between international financial centers and what they can offer financial institutions in terms of infrastructure and other advantages, such as the strength of the ecosystem supporting financial services (e.g., tax, legal, accountancy services, etc.). Expertise in fintech and ESG finance and investments should also be factored in. The great rivals of London and New York are ranked as the world's top financial hubs, with Asia Pacific centers closely behind.[6] What will be the impact of Brexit in 2021 and the loss of passporting on London, until now, Europe's unrivalled financial capital? Although UK clearing houses for derivatives and central securities depositaries have been granted temporary equivalence by the European Union (EU), it is estimated that up to a quarter of financial services in the City of London is EU-related and half may need to relocate in the absence of the European Commission granting equivalence.[7] London's closest EU rival is Frankfurt, which is strong in banking. However, there are other rival competing centers within the EU likely to gain from London's loss: Amsterdam for trading platforms, Luxembourg and Dublin for fund administration and Paris more generally.

Of course, London may benefit outside the EU with the ability to diverge and develop a more nuanced, flexible, rulebook better tailored to its needs, opening its markets further to business internationally. UK government policy favors "open, well regulated markets" with the UK at the "cutting edge of payment technologies."[8] Nonetheless, New York and the Asia Pacific centers may gain from a London isolated from its hinterland. APAC centers are growing rapidly reflecting economic growth in the region with China enjoying the largest share of initial public offerings in tech stocks in 2020. Of course, with increasing digitalization and remote working turbocharged by COVID-19, geographical proximity to any specific financial center may be increasingly less important in the future.[9]

Trends — exchanges, clearers and depositaries

In contrast to banks and insurers, exchanges and clearers (and the firms that service them) have seen high average revenue growth over the last decade with good operating margins, although depositaries have fared less well. In part, this was due to post-2008 regulations mandating trading on exchange, centralized clearing and risk management measures such as requiring an initial and minimum margin. Again, as for other sectors, revenue growth has been highest in Asia Pacific followed by the US and then Europe. In the future, the greatest revenue growth is likely to come from process efficiency and data management solutions for both buy and sell-side.[10] As has been alluded to above, there are a number of trends in recent years affecting the industry.[11]

- Concentration and diversification: After a wave of industry consolidation between exchanges, the biggest groups now dominate global markets where they also control clearers and a variety of financial market data and information businesses. Given the large-scale consolidation that has taken place and increasing competition concerns, future M&A focus is likely to center on smaller regional platforms and niche fintech offering bespoke solutions. Acquisition of the former will pose challenges in managing the integration of different operating systems and technologies.

- Focus on the buy-side: With sell-side firms such as investment banks and brokers facing more expensive capital and higher costs, FIP businesses are increasingly offering new services to the buy-side such as asset managers, for instance, research and analytics.

- New technologies: Technologies such as artificial intelligence and blockchain are creating opportunities to offer new and innovative products in data and analytics, although this is counterbalanced by the growing commoditization of traditional data services. Many observers consider that FIPs will need to think and act more like big technology firms, for example, by providing state-of-the-art technology solutions and increasing investment in innovation.[12]

- Fintech: A growing number of fintech businesses are bringing innovation, increasing competition and, above all, disrupting business models. Institutions are acquiring or partnering with fintech businesses to lower costs and boost margins.

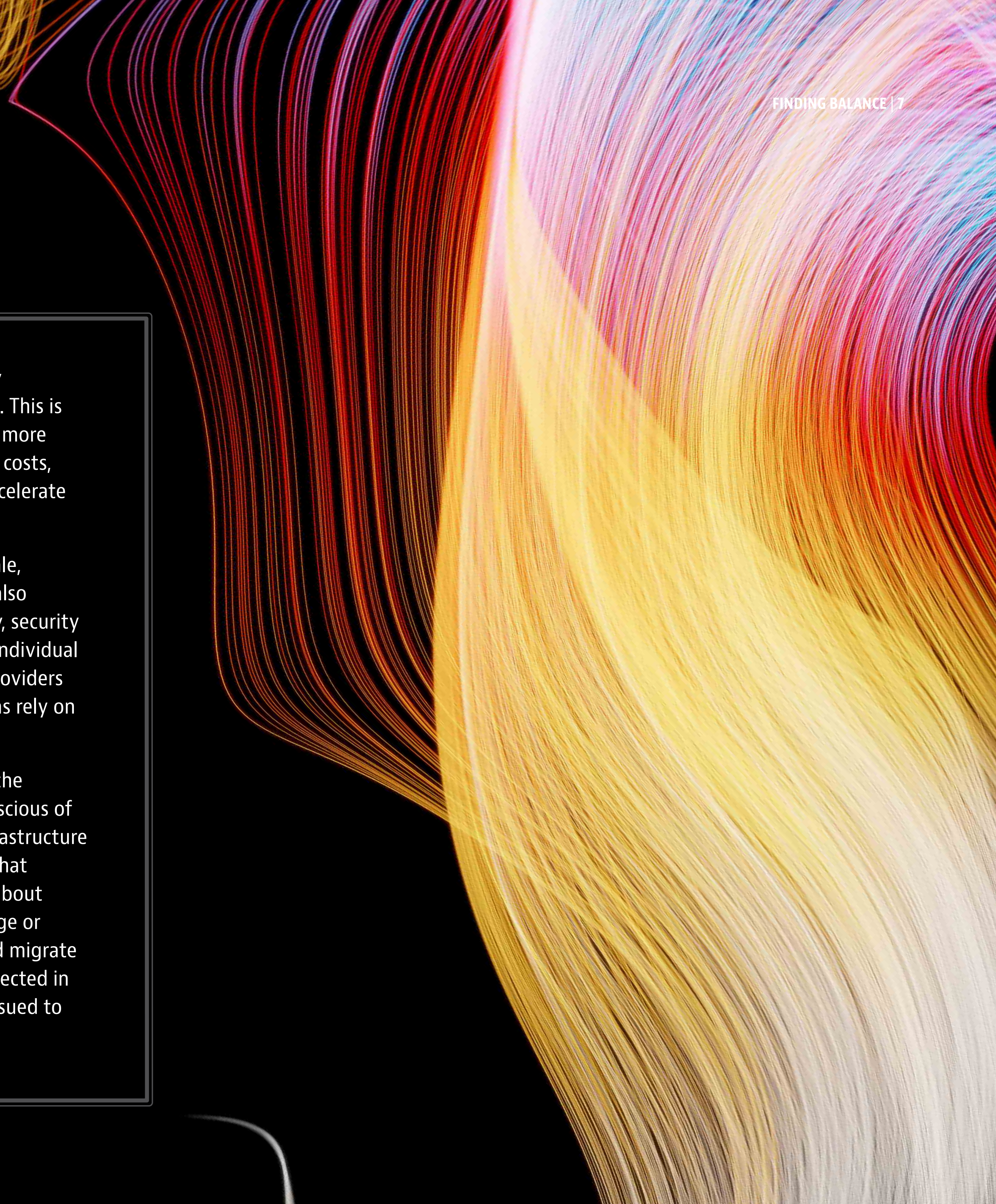
- Outsourcing: FIP businesses are responding to the trend by financial services firms to outsource services that are not core to their businesses, by offering solutions for risk management, regulatory reporting and compliance (e.g., credit, KYC and AML). To meet cost and quality requirements, outsourced providers will need to achieve sufficient scale, especially in the context of Big Tech's offering in this sphere. *See box on cloud services.*

CLOUD SERVICES

Cloud service providers, which usually sit outside the regulatory perimeter, are fast becoming part of the financial infrastructure. This is because many financial institutions are becoming progressively more dependent on cloud computing because of its ability to reduce costs, enable firms to adopt and scale new technology on demand, accelerate digital transformation and facilitate mandatory data analytics.

While cloud services offer advantages, such as economies of scale, flexibility, operational efficiencies and cost effectiveness, they also present challenges in terms of data protection, banking secrecy, security issues and concentration risk. These are challenges not just for individual businesses, but also at a systematic level because large cloud providers risk becoming a single point of failure when so many institutions rely on them.

Regulators globally — led by the EU, the US (e.g., the Office of the Comptroller of the Currency) and the UK — are increasingly conscious of cloud risks, including the concentration of so much banking infrastructure and information in the hands of the few large tech companies that dominate the cloud services market. Regulators are concerned about continuity of service for customers in the event of a cloud outage or other cyber risks, and for banks to have the ability to access and migrate data off the cloud and back on to their own systems. This is reflected in a growing number of regulatory requirements and guidelines issued to regulated institutions on their use of cloud services.



Trends — payments sphere

In Europe, payment revenues are likely to grow moderately over the next five years but more slowly than in recent years depending on the strength of the economic recovery. The areas of greatest potential growth are expected to be in Eastern Europe and Russia. While new payment services under the EU's second Payment Services Directive (PSD2) and the Open Banking initiative enjoy a high profile, it is early in their development and their impact on the market has been limited to date.[13] One obstacle is a lack of standardization of APIs across Europe — with national only solutions — and better regulatory coordination is needed over a multitude of different systems and platforms. The European Payments Initiative is an attempt to provide a solution.[14] It brings together 16 banks with the objective of creating a "unified payment solution" for consumers and businesses, including a payment card and a digital wallet that would cover in-store, online and person-to-person payments, as well as cash withdrawals.

The payments sphere is becoming crowded. The impact of new technology, for example, the increase in the digitalization of payment services and the impetus created by innovative new payment regulations such as PSD2 and Singapore's Payment Services Act are creating a new varied payments ecosystem. The fundamentals remain strong for businesses and favorable trends will favor growth. Among these are:[15]

- Move away from cash: The acceleration to electronic payments away from cash has been given increased impetus by COVID-19. Even traditionally cash loyal countries such as Germany and Japan have seen a significant decline in the use of cash. Other countries where digital already has a high and growing level of acceptance — the UK, Australia and Canada — have seen an increase on adoption rates. In the US, digital wallets have seen mass levels of adoption, which in the ordinary course would have taken place over several years. A recent card scheme customer survey showed a major change in US consumer behavior toward contactless payments, which include mobile wallets and "tap-to-go cards due to health concerns with using cash."[16] Such developments are not surprising and not without precedent. In Asia Pacific, following SARS in 2003 and MERS in 2005, digital payments grew exponentially. It is also fair to say that the move away from cash is pushing at an open door in the sense that many governments favor electronic payments as a means to counter the black economy.
- Growth in e-commerce: The combined effects of social distancing and lockdowns have given the trend toward e-commerce added impetus. Take-up has grown even among older generations, which, until now, were less inclined to transact online, and the range of businesses using e-commerce has increased, especially smaller and medium-sized businesses. With the growth in alternative payment methods for goods and services purchased online, credit cards may lose market share to online payment systems and Open Banking-style payment initiation service providers. The use of digital wallets, an electronic device that stores payment information in one location, has also increased due to COVID-19 . We are also seeing central banks and Big Tech a looking to develop digital currencies.

- Digitalization of wholesale banking: COVID-19 is accelerating change across business banking and not just in respect of payments themselves, but also in related activities such as cash management, trade finance and working capital solutions. The importance of providing these services to business users will continue to drive revenues. Traditional banks remain in pole position to retain this business, but to continue do so and particularly for small and medium enterprise customers banks must raise their offer and improve the customer experience. Also worthy of mention is the rise of "banking-as-a-service." This concept allows third parties partnered with licensed banks to include digital banking services in their own product offerings enabling, for example, the provision of payment cards and credit.

- Continuing consolidation, alliances and joint ventures: The payment sector has seen considerable M&A activity most notably among payment processors and acquirers. This is driven by the need to scale up operations, move funds more quickly and profit from taking up more roles in the payment value chain. For example, in the context of the payments ecosystem, an institution might act both as a payment gateway by transmitting payments and as a processor by communicating transaction information. This trend is likely to continue and may involve other participants, such as issuers, as payment providers look to improve their competitive position by offering more value-added services to customers (e.g., real-time merchant reporting and fraud prevention). Continuing regulatory changes and cost pressures on traditional bank providers to upgrade their technology could also drive transactional activity.

PAYMENT TRENDS

Card schemes

- Increasing scrutiny of scheme fees following EU capping of merchant interchange fees
- Issuers and acquirers calling for new value-added services (e.g., working capital and customer relationship management)
- Growing competition from national/local alternative schemes

Card issuers

- Increasing regulatory scrutiny of issuer fees (out of which, e.g., loyalty schemes funded)
- Higher levels of cardholder delinquencies in light of COVID-19 impact on economy
- New market digital entrants and increasing competition

Merchant acquirers

- Commoditization of acquiring services is pressurizing fees
- More regulatory scrutiny around processing firms after recent high-profile failures
- Disintermediation of SME acquiring by independent software vendors offering payment solutions

Wholesale banks

- Lower entry barriers for new providers through banking-as-a-service providers
- Customer expectations over fully digital, real-time, bespoke customer journeys
- Costly payments infrastructure and demanding regulatory standards

Operational risk

While all financial institutions are subject to operational risk, the issue is particularly acute for FIPs as failures have a potentially wider impact on financial stability and the operation of the wider market. Moreover, it is fair to say that operational risk and resilience has risen up the list of regulatory priorities in recent years.[17] This can be linked to increasing levels of digitalization and outsourcing in financial services, especially in this subsector. A recent example in the payments sphere involved a card issuer offering prepaid and charge cards. Following a technology malfunction by its outsourced card processor, there was a complete failure of IT services for many hours, during which thousands of customers were unable to use their cards. Regulators concluded that the institution lacked adequate processes to identify and monitor these arrangements, especially over their contingency plans during such a disruptive event. Not only was the institution fined, but its reputation also took a significant hit.

Therefore, it is vital for financial institutions to strengthen their resilience to such risks. This involves identifying their most important services and understanding the systems and processes which support them, including anycritical services that are outsourced. Additionally, there is a need to understand the impact of a failure, say an outage, and how quickly a system or process can be recovered or substituted. Payment providers were tested by the collapse of a major European payment processor this summer and, in contrast to early stages of the pandemic, exchange groups experienced higher levels of disruptions to trading in a number of locations in autumn 2020. As referred to above, however, the picture was broadly positive with regard to resilience during the initial COVID-19 inspired market turmoil, in large part due to the market infrastructure and trading reforms put in place since the 2008 financial crisis. Nonetheless, with digitalization increasing and the way in which services are provided changing, new vulnerabilities are constantly emerging and, of most concern, cyberattack incidences are growing. This requires continual and expensive investment in IT, including systems and processes with informed oversight of outsourced services. The challenges vary from entity to entity. Traditional providers will have to manage, upgrade or migrate from legacy systems, while new market entrants experiencing rapid growth may find that their compliance and risk functions are not keeping pace with the demands placed on them.

Endnotes

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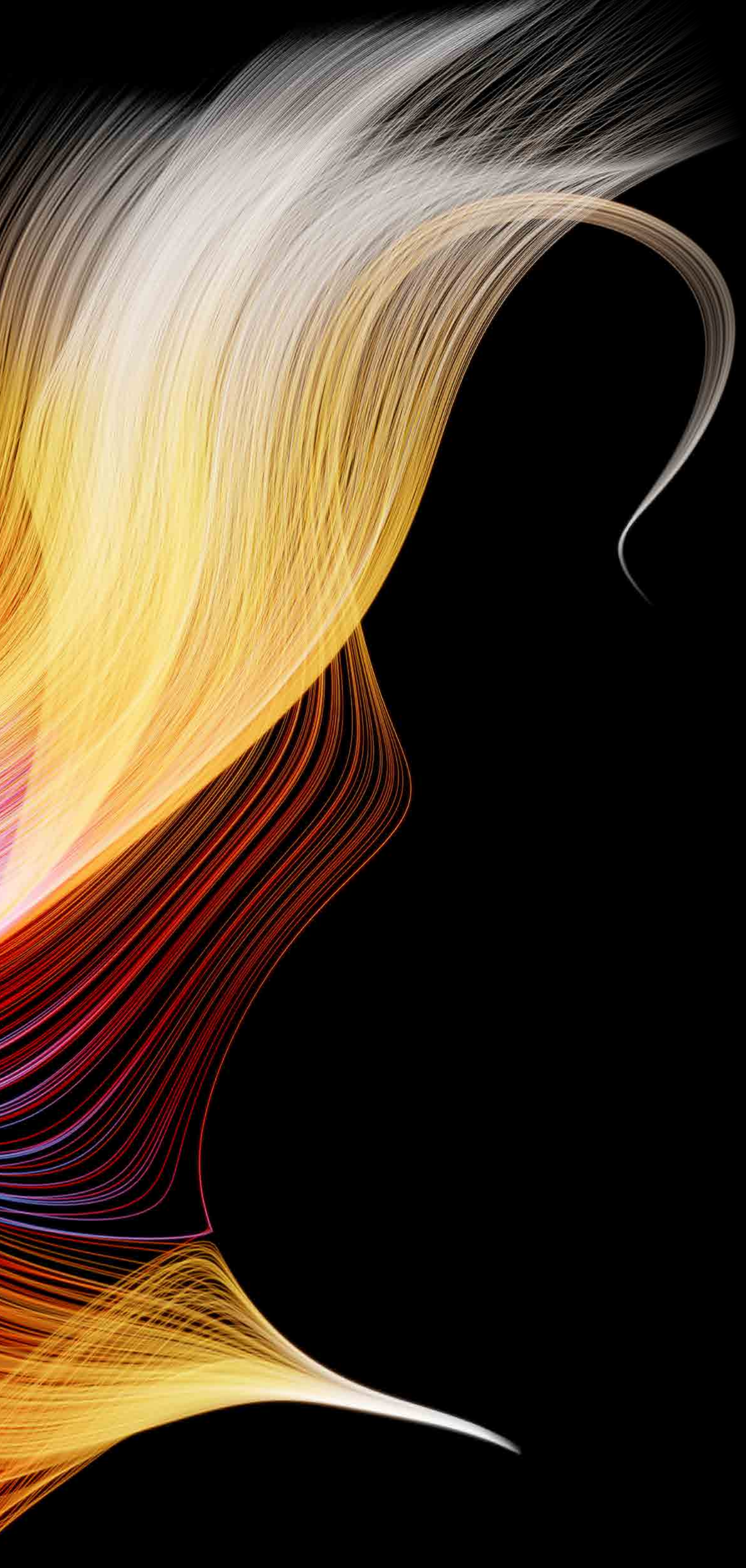
The Resilience, Recovery & Renewal Model

Our Resilience, Recovery & Renewal model is helping organizations navigate the business and legal impact of the COVID-19 pandemic. While most businesses will pass through all three phases of the model, the phases themselves are non-linear and may recur or overlap, particularly for those with global operations. Wherever you are in your response to the pandemic, we will help you with the services and resources you need. Visit our Resilience, Recovery & Renewal Roadmap to Stability hub for more information. Also, visit our 3R Resource Center for the latest legal and regulatory updates from around the world.



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