THE CHALLENGES FACING BROKERAGE

And the Outsourcing Options to Help Firms Survive

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Executive Summary

The securities industry is challenging turf. During the last decade, the markets have undergone numerous crashes and rallies. That volatility has prompted countless investors to flee, and many of those who have not fled, now wish that they had. Managing a brokerage business in this turbulent environment has become, to say the least, extraordinarily tough.

The usual regulatory changes, this time driven by Dodd-Frank and other SEC rulings, have beleaguered brokerage firms. Shrinking demand and increased competition have squeezed profit margins. Customer confidence is at an all-time low; tumultuous markets have many investors thinking that a 0.04 percent rate of return on a one-year CD sounds pretty good.

Outsourcing has not been utilized as much in the brokerage space as in other financial services businesses, in large part because securities transactions are so regulated, time sensitive, and complex. However, cost pressures and market volatility are now forcing companies to look outside their walls for help. Consulting companies and outsource providers, meanwhile, are working hard to find ways to support brokerage clients, by introducing them to new technologies, industry best practices, and variable pricing models. Most of the brokerage companies contacted by HfS Research either have implemented an outsourcing model in the last couple of years or are aggressively looking at available options as at least one answer to their many challenges.

In this RAPIDInsight, HfS Research examines the specific challenges facing brokerage companies and how these firms are leveraging outsourcing service providers to remain competitive. We look at the advantages brokerage firms can generate through different outsourcing models and we profile two providers that are demonstrating value in this space.

More than a Decade of Industry Turmoil

In the early 1990s, the United States witnessed one of the largest bull markets in history. The Dotcom businesses had the country in a frenzy, and technology companies were trading at all-time highs. The climate quickly changed, starting in 1997, when a series of events reshaped the U.S. securities industry, including:

- **October 27, 1997: The mini-crash.** The Dow Jones Industrial Average (DOW) dropped 550 points in a single day, forcing the market to close early.
- **Sept 11, 2001: The worst terrorist event in U.S. history.** The stock exchanges remained closed until Sept. 17 and when they did open, the DOW dropped 684 points in a single day and 1,369 points over the next week.
- **March 2002: The stock market downturn of 2002.** Between March 2002 and March 2003, the Dow dropped over 3,300 points.
- **The 2008 Recession.** The bottom hit in March 2009 when the Dow hit 6,500.

Each of these events created significant issues for both investors and the brokerage companies servicing them. Many investors pulled out of the markets and many others lost much of the market value they had held.

Persistent Industry Challenges

Revenue has declined and costs have risen amid investors' retreat and the continuous reforms that have pushed securities companies to pursue more risk-averse practices. Key challenges facing the brokerage industry include:

- **Regulatory Reform.** Dodd-Frank's more than 400 rules regulating the financial services industry are in the process of being implemented. The SEC is currently working on provisions for 90 Dodd-Frank rules that impact brokerage business. Companies are still trying to figure out what that impact is and how they will have to adapt their business models to comply with the new regulations.
- **Volume Variability**. The volatility of the securities markets has volume fluctuating daily, weekly, and monthly. The 2009 market crash resulted in reduced trading transactions, and these have yet to fully recover. Many brokerage firms are transitioning to fee-based pricing. For most firms, however, a significant percentage of revenue still stems from transaction-based commissions.
- **Margin Pressure.** Back-office operations costs are increasing 5 to 7 percent annually and must be lowered to attain appropriate profit margins, according to leaders in the brokerage business. In addition, revenues are struggling under the weight of competitive pricing and low interest rates, which put pressure on the cash spreads that are a substantial part of industry revenues. Lack of investor confidence is preventing the acquisition of new assets; consumers are likely to hold back in such a high-risk market. Even revenues from asset management fees are dropping when the markets retreat and asset values shrink.
- **Lack of Technology.** Many brokerage companies are struggling to keep up with technology changes in the industry, while ongoing manual processing continues to increase operational risk.

The Role of Outsourcing in the Securities Industry

Historically, most brokerage companies have limited outsourcing to a few areas, such as account-opening functions and financial areas like reconciliations. Many executives have felt that regulatory challenges governing third parties outweighed the benefits of moving deeper into the outsourcing space. All this is now changing, and the irony is that regulatory changes, driving up costs and requirements for the brokerage companies, are driving firms to look to consulting and outsourcing providers for solutions to their business challenges.

Brokerage companies are rethinking their models to hedge against future changes that will increase and decrease trade volumes. They must be able to provide better information to their clients, and more quickly. Their clients can turn to other options, including online brokerage services, banks, and independent brokers. As a result, brokerage firms must raise their level of performance. Outsourcing may just provide the support they need to survive, even thrive.

Outsourcing securities work still comes with drawbacks. The SEC and other regulatory bodies will want to get more involved, to ensure that risks are being mitigated. Many hours will likely be spent reassuring regulators that programs and processes will be in compliance, more so than if these were internal. Another disadvantage is the loss of the institutional knowledge, and finding licensed staff can be difficult with many of the providers. In the end, each company must evaluate the pros and cons of outsourcing, although not without giving the potential advantages a very close look.

Advantages of Outsourcing Brokerage Services

Some outsourcing benefits for brokerage firms include:

- Economies of scale that can be leveraged using a provider. Cost of support of operations can be reduced by providers when they support multiple relationships. A large percentage may be dedicated to staff but many support areas are shared.

- The ability to hedge against volume variability by using different transactional models. Providers will present transaction pricing to buyers; in this model, the provider takes the responsibility of managing the staffing levels required for processing. Providers will require a 60–90 day forecast to be able to manage staffing needs.
- Access to lower-cost locations. Brokerage firms are located in many of the most expensive areas in the U.S., including New York and California. Outsourcing offers access to less expensive locations, both domestic and offshore.
- Process discipline. Outsourcing providers are known for their ability to create and follow processes, while brokerage firms are known for their trading discipline. Brokerage firms are learning to appreciate the process discipline that leading outsourcing providers supply.
- Centralization of processes and locations. In many brokerage firms, processes are still decentralized according to geography and customer base. By leveraging outsourcing models, a centralized model can provide cost and best practice advantages.
- Improved use of capital. The art and science in trading technology should be where companies allocate their technology investments, not in customer relationship management and workflow technology, which are widely available and not differentiating. Service providers can provide access to better and lower-cost technology solutions in these commoditized areas.

Exhibit 1: Business Areas to Consider Outsourcing

Data Management	Research & Analytics/Account Activities	Trading & Settlement	Risk & Compliance	Investor Services/Recons
Client Data Management	Equity Research	Trade Confirmations	Pre and Post Trade Compliance	Record Keeping
Security Data Management	Portfolio Analysis	Cash and Security Settlement	Market Risk Monitoring	Shareholder Reporting
Static Data Management	New Account Setup	Exception Management	MIS and Reporting	Trade Confirmation
	Account Transfers	Collateral Management	AML/KYC	Security and Cash Recons

Source: HfS Research 2012

Criteria for Choosing Providers

Because of the uniqueness of the business environment, we advise brokerage clients to leverage different criteria during service provider selection. In particular, our research indicates the following factors should be part of any evaluation:

- **Brokerage Experience**. The level of experience and scale is the most important quality in a brokerage outsourcing partner. This includes the experience of the delivery teams and also the account management teams supporting the buyer. One of the top challenges faced by providers is to be able to recruit and retain top account managers who bring the business acumen needed to support the client.

» **Overcoming Singular Focus**. Providers must have the ability to drive cost AND go beyond to support business goals including innovation and business improvements. Buyers and providers need to partner to foster innovations into business and IT process outcomes.

» **Thought Leadership**. With the changes in the regulatory environment, an organization that can provide advice and guidance to the buyer on brokerage trends will provide valuable benefits. Smart buyers know that they need as much external advice as possible, but not all firms have the consultative experience to support their needs.

» **Technology**. Workflow, image, and processing platforms can add new levels of process performance, reporting advantages, and preservation of capital.

» **Pricing Models**. A provider that can offer a mix of pricing models including transactional, outcome base, and fixed staff models, will demonstrate experience level and confidence in the brokerage space. Buyers need flexibility, and traditional ARCs and RCCs may not be enough to support dramatic changes in trade volumes.

» **Global Footprint**. Guided by the client company's strategy, the ability to expand into new markets and leverage lower cost geographies can play a key role in business differentiation.

Outsourcing Servicing Options: Two Examples

This is not a space in which every provider can compete. HfS Research looked at 10 of the largest global outsourcing providers and found that less than a third have the required experience. Brokerage outsourcing is very different – and more challenging – than basic business process outsourcing (BPO) work in many financial services areas. It requires a greater level of experience. Simply being able to map a process and train a new team will not work, despite the sales chutzpah that fills PowerPoint slides. Providers that want to be in the brokerage business will have to make significant investments in technology, experienced leaders, and staff. One provider HfS Research has spoken has partnered with a local university in India to support staff training and licensing; this has led to the licensing of more than 50 analysts in the last two years.

Our research also found that three of the world's largest global outsourcing providers did not have relevant experience in the brokerage space. Another four had less than 1,000 total people performing the spectrum of brokerage functions, including data management, reconciliations, new client setup, and account transfer activities. Among the providers that are performing these functions, all of the domain specific work is being performed out of their locations in India. Other locations being developed to service the brokerage market include the U.S. the Philippines, and other areas of Asia.

Because of the complexity of securities-related work, we have seen the emergence of niche players who focus primarily on the brokerage space. These niche experts, such as Thomson, Fiserv, and Broadridge, offer deep domain experience, technology platforms, and domestic locations that are appealing to buyers. Meanwhile, the large global outsourcing providers continue to enjoy a strong value play among many of the larger buyers that have processes and technology in place. They have slowly been building capabilities in this space over the last decade, investing significantly in hiring experienced teams and running extensive training programs. Companies like Genpact, Infosys, and Wipro have demonstrated their effectiveness in the brokerage business with their expansive geographic footprint, low-cost staffing models, and ability to drive dramatic process improvements.

Both the brokerage industry niche provider and the global outsourcing provider can be effective, depending on the customer's needs. In Exhibit 1, HfS Research profiles two of these companies with very different value propositions.

Exhibit 2: Select Service Providers in the Brokerage Space

Provider of Brokerage Services	Profile
Broadridge	• A $2 billion company with 6,000 employees serving the brokerage industry. • A niche provider of security services, from investor communications to security end-to-end processing. • A spinoff of ADP. • Primary servicing location for securities is Wheat Ridge, Colorado. • Key differentiator: Depth of experience in the brokerage space – a combination of deep domain experience with proven technology solutions. • Pricing models will include staff related and transactional. • Processes include: Data Management, New Act Setup, Client Communications, Shareholder Reporting, and Regulatory Reporting. • A few key clients include Charles Schwab, Pension Worldwide, and SG Americas Securities.
Genpact	• $1.6 billion company with 56,000 employees, serving all major business industries. • A large global provider of outsourcing services, grown out of the GE Captive started in 1997 in India. In 2005, Genpact was spun off as a separate entity. • A global company, but India serves as the primary location for servicing the brokerage market. • Key differentiator: Ability to provide cost and value advantages by leveraging process improvement and business experience. • Pricing models will be predominantly staff related. • Processes include Corporate Actions, AML/KYC, Post Trade Settlement, New Act Opening, Equity Research, Recons, and Regulatory Reporting. • Select Clients include: Wells Fargo, Key Bank, and First Allied Securities.

Source: HfS Research 2012

Broadridge was spun off from ADP in March 2007, and the $2 billion in revenue the company generated in 2011 was associated with the brokerage business. Broadridge brings deep knowledge and turnkey solutions to buyers, especially small- and mid-market brokerage firms looking for thought leadership and direction to move to the next level. Although not a low-cost salary arbitrage player, Broadridge' s U.S.-based operations provide a wealth of technology that will reduce companies' capital outlay and drive much higher levels of automation and functional capabilities.

Genpact is a leading provider of outsourcing services and is similar in size to Broadridge. Genpact has extensive brokerage-related processing experience tied to relationships with some of the leading global financial institutions. That is where the similarities stop: Genpact's value proposition starts with a much lower cost salary model available through its offshore locations. Second, Genpact is able to leverage its process and analytics acumen, as well as much of its clients' technology platform, to improve process performance through tools like 6sigma and lean manufacturing.

Both Broadridge and Genpact provide high-level services for clients – Broadridge for small and mid-market clients looking for platform solutions designed to improve investor communications and transaction processing capabilities; Genpact for larger institutions seeking a provider with a global footprint to support improvements to existing programs and processes.

Key Takeaways

- The brokerage business continues to experience a great deal of pressure from regulatory reform, client attrition, and a tough competitive environment.
- Many brokerage companies that had not previously considered outsourcing are now looking to integrate outsourcing into their corporate strategies.
- Outsourcing can provide extensive advantages and disadvantages for mid- and back office areas; brokerage companies need to consider both in their decision to outsource work.
- Not all outsource providers and consultants can support the brokerage business, so selecting the right partner is critical in this space.
- Both global outsourcing providers and niche brokerage providers have the capabilities and experience, so buyers should choose the one that best fits their strategy. In some cases, they might find benefits in including both types of providers.

In addition to the areas covered above, the HfS Research Blueprint covers additional challenges that the industry is facing. The Blueprint is a composite of views from the HfS Research 50 outsourcing leaders from across the industry. It covers the challenges that the industry continues to face in this space, including:

- Overcoming the singular focus on cost that strips the industry of its value;
- Leveraging outsourcing as one of a variety of vehicles to achieve business objectives;
- Service providers need to invest smarter in their account management teams; and
- Buyers and providers need to partner to foster innovations in business and IT process outcomes

To read more about the HfS Research Blueprint: http://www.hfsresearch.com/A-Blueprint-for-the-Industry-known-as-Outsourcing.

About the Author

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Michael Koontz is Senior Vice President and Research Director for HfS' Banking, Financial Services and Insurance (BFSI) analyst advisory practice. He provides leading-edge and practical research into global outsourcing and shared services strategies in the BFSI sector, which is in high demand from HfS Research's 120,000-strong readership base and knowledge community, which has a very strong representation from global financial services institutions.

Looking into the past, present and future of the outsourcing and shared services markets, reinforced with HfS data and supported by its global analyst team, Michael supports HfS financial services clients in creating strategies for their businesses. He examines the core financial services industry dynamics driving global sourcing strategy, as the boundaries between IT, Shared Services and Business Process Outsourcing strategy continue to blur.

Prior to joining HfS, Michael spent 4 years working as SVP of BFS on the provider side of the business, working with many of the top financial institutions in North America. Michael supported the creation of new capabilities, account management and new business development. Michael was at Wachovia Bank for 14 years, where he was the SVP of Outsourcing Strategy and Governance; leading over 130 transitions, and managing over 1000 SLAs, over four countries and three providers. Michael played a critical role in the creation of one of the most creative offshore models in existence, the idea of the virtual captive.

Michael held many other roles within Wachovia, including; CFO for Banking Operations, Operations Manager in Check Processing and Research Adjustments, and Process Improvement Leader in Treasury Services.

Michael has been very active in the offshoring world for the past 10+ years, and has spoken at many industry conferences including: the Gartner Offshoring Summit, TPI, The Conference Board, BAI, SIG and many others. He was selected by Finance and Accounting Outsourcing Magazine in 2006 and 2008 as one of their "FAO Superstars".

Michael has a BS in Finance from the University of Tennessee, and an MBA from Kennesaw State University in Georgia.

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HfS Research is the leading analyst authority and knowledge community for the global services industry.

In addition to researching business services and technology services strategies, HfS educates and facilitates discussion among the world's largest knowledge community of services professionals, currently comprising 120,000 subscribers. HfS provides a collaborative platform for the largest, highest impact, and most frequently visited professional community in the global services industry, offering rapid and insightful commentary on, analysis of, and debate about enterprise shared services, outsourcing, and global operations dynamics.

In 2011, HfS was awarded Outsourcing, BPO and Services Analyst Firm of the Year by the International Institute of Analyst Relations (IIAR), the premier body of analyst-facing professionals, and runner-up for overall Analyst Firm of the Year. Led by recognized industry expert Phil Fersht, HfS Research differentiates itself with its global team of expert services analysts with real industry experience, provocative and opinionated research, unrivalled market analytics, and a view of technology as an enabler for business process improvement. Its on-demand expertise relationship model helps clients leverage HfS knowledge and strategic insight in a rapid, responsive and engaging manner.

HfS Research also manages the HfS 50 Sourcing Executive Council, the premier peer discussion group for enterprise outsourcing and business services executives. This by-invitation-only program fosters networking, debate and best-practices sharing among the most senior sourcing executives of large global enterprises. This powerful forum is shaping the strategic direction of the sourcing industry, influencing other buyers, service providers and intermediaries across BPO, ITO and shared services domains. HfS hosts and facilitates regular meetings, webinars, introductions and peer networking opportunities for HfS 50 members, and its analysts contribute to these interactions with candid, unbiased opinions based on current, relevant research, benchmarking data and deep sourcing governance expertise.

Now in its sixth year of publication, HfS Research's acclaimed blog "Horses for Sources" is widely recognized as the leading destination for collective insight, research and open debate of sourcing industry issues and developments. The thriving HfS LinkedIn community includes over 17,000 industry professionals who share views and information daily. More information about HfS Research can be accessed at www.HfSResearch.com. The company can be followed on Twitter at www.twitter.com/horses4sourcesand LinkedIn by joining The BPO and Offshoring Best Practices forum.

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