BANKING & MARKETS

Annual Integrated Trading Solutions Summit:

An Age of Disruption

NORTHERN TRUST

Integrated Trading Solutions

Northern Trust's Integrated Trading Solutions team are dedicated to helping our clients solve their challenges across the trading spectrum. Achieving alpha is more difficult than ever before, and by outsourcing their trading functions, clients can focus on investment decisions that deliver meaningful results. Northern Trust's outsourced trading capability combines worldwide trading expertise in equities and fixed income, exchange traded derivatives, futures and exchange traded funds (ETFs) across global markets

Northern Trust currently supports more than 90 Integrated Trading Solutions clients across the globe, including in the United Kingdom, United States, the Netherlands, Switzerland, Australia, New Zealand and Asia.

For more information on Northern Trust's annual Integrated Trading Solutions Summit or any of the themes discussed, get in touch:

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Introduction

Northern Trust hosted its 4th annual Integrated Trading Solutions Summit in London in March 2024, bringing together the asset manager community, Northern Trust's Banking & Markets leadership team, and expert market practitioners to examine how asset managers can stay relevant and competitive as the market landscape continues to evolve.

An exclusive event for Northern Trust's existing and prospective outsourced trading clients, the Summit offers participants a unique opportunity to connect with peers in an intimate and confidential setting, to benchmark their thinking on our industry's most pressing challenges, and explore common concerns.

In an age of disruption the challenges facing the investment industry are substantial. As asset managers continue to grapple with cost pressures as they navigate growing regulatory and technological requirements, this year's Summit explored key themes ranging from the current state of generative AI and its momentum in the financial services sector, through to regulation, research and costs and the move T+1 with its significant implications for portfolio management.

Riding the Wave of GenAI

Asset managers continue to grapple with cost pressures as they navigate growing regulatory and technological requirements. Consolidation is an ongoing trend, the bifurcation of active and passive continues, and more than ever firms need to think about their unique value propositions. Whether re-assessing business models or enhancing customer relationships, how they engage with technology and AI, or their operational approaches, asset managers need to master the art of differentiation if they want to thrive.

An area where investment businesses can differentiate themselves is how they think about and engage with GenAI, according to experts, who spoke about the substantial opportunities – and challenges - that GenAI poses to the investment industry.

Paul Raspin, Founder and Managing Director at Stratevolve, outlined how it has become organisations' most strategic business priority for 2024, given the speed at which GenAI is growing and transforming the landscape. The OpenAI chatbot platform ChatGPT, for example, was launched in November 2022 and took just five days to hit one million users. By January 2023 it had 100 million users and now that figure stands at 180.5 million[1], bringing GenAI well into the mainstream.

According to Raspin, within the financial services industry:

80%

Most executives have had some sort of exposure to GenAI. 80% of executives have exposure in a work or personal setting, and 40% use some form of GenAI on a daily basis

30%

Approximately 30% of financial services firms are engaging with GenAI experimentation within one business function, while mature firms are more likely to use it across five different business functions

40%

40% of boards have raised GenAI to a board level issue in 2024 alone

> On average, expectations are that this technology, through productivity alone, could add 9% to 15% to the bottom line.

PAUL RASPIN
Founder & Managing Director
Stratevolve

> A professor of mine said famously that productivity isn't the only thing, but it is the most important thing. This is the first time in my career that something truly transformational in this area may be at hand, and I'm very, very excited about it. The latest generation of tools has the potential to boost growth, sustain debt, raise living standards, and justify strong asset prices.

CARL TANNENBAUM
Chief Economist
Northern Trust

From Inflection to Execution

Speakers felt that businesses should be putting in place both AI and GenAI strategies, pointing out that having a robust AI strategy resulted in productivity savings and benefits from GenAI. By using a top down approach, users can create a more joined up and comprehensive framework, one that uses data and GenAI in a more integrated way.

"It is really important to think about how your strategy is positioned relative to the other strategies within your organisation. It needs to be positioned to support your overall corporate strategy, because as advanced as it is, GenAI is still a technology, and therefore ultimately it is an enabler," said Raspin, pointing out that any GenAI approach also had to fit in with technology and digital strategies, and cloud and infrastructure developments within an organisation.

Barton warned about operating any GenAI strategy in a silo. "The worst outcome we have seen over the last year or two are organisations that have a specialist AI group that then fails to get it out there because they didn't speak to their business or technology people."

> There are a number of pressures that you are all experiencing in asset management and wealth management, and that includes downward fee pressure, the move from active to passive, increasing costs, and increasing regulation. Organisations are also really grappling with how they introduce new products and diversify those products to be successfully launched into the market. So that is a whole lot of pressure. What GenAI does is potentially alleviate those pressures, through productivity savings in particular.

PAUL RASPIN
Founder & Managing Director
Stratevolve

> There are challenges on the talent, and on the asset and wealth side in particular. We have very few firms that are actually thinking about putting this technology into production, for many reasons including the security aspect and the privacy aspect. And so there are firms like OpenAI and Microsoft that are working relentlessly to solve that problem.

THOMAS BARTON
Vice President
Artificial Intelligence
Blankfactor

> The year 2023 was the year of inflection, and I would say 2024 is the year of execution. There are a lot of challenges, and regulation is not keeping pace with the technology, but we are confident that we can mitigate that risk and move forward.

THOMAS BARTON
Vice President
Artificial Intelligence
Blankfactor

GenAI: Data is Your Asset

The importance of data

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What is really different here is the value of data. It is about having unique data that gets put into these large learning models where you can get a unique output. That output gives you some form of competitive differentiation.

PALLAVI GUPTA
Managing Director, Banking and Financial Services
Stratevolve

Why context is everything

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When you train these models, it is really important to understand the overall context. That training can only come through people that have business domain expertise. It can be internal, or it can be external. It can go through your solution providers, but if you do not provide a model with the right context and understanding, it is going to be prone to error, and you're going to end up with these biases and hallucinations that just won't justify the investment and the outcomes you expect.

PALLAVI GUPTA
Managing Director, Banking and Financial Services
Stratevolve

What data means to organisations

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I spent the better part of a year in asset management defining everything. What type of data is it? What is the domicile? What is the vehicle type? What does duration mean to us? What does ESG mean to us? Without context, asset projections fail, but when we use product types that are well defined, we get better answers and better output.

THOMAS BARTON
Vice President
Artificial Intelligence
Blankfactor

The Future as Robot

On the issue of how much of a role GenAI will play in investment decision-making and advice, speakers stressed the importance of businesses making their own decisions, but the need to engage with the fast-moving issue.

"This is still a relationship-driven business. The technology is great, and we can generate some real insights, but ultimately, think of who is going to place assets with you and what it takes for them to place $100 million under management. It is your relationship and your investment. It is also about your uniqueness and your differentiated offerings and knowledge," according to Barton.

When it comes to research however, Barton is unequivocal. "Yes, this will be your analyst of the future. This will happen. We're already seeing analysis happen in minutes and you will be so much more productive."

> ESG regulatory changes are forcing managers to make a greater degree of fund level ESG disclosure. Regulators are concerned about greenwashing and there is now a greater level of proof required on the part of the asset manager. For an industry that has had a really hard time recently, ESG is one of the few bright spots where they have been able to grow their active AUM, but now that burden of proof is rising.

NEIL SCARTH
Principal
Frost Consulting

Regulation, Research and Costs

It is difficult to imagine a time where regulation has added so much complexity to margins, but regulation is giving the industry a lot to think about, in different areas.

For non-US managers, a key issue is the cost of research. In the UK, Rachel Kent was appointed chair of the Edinburgh Reforms' investment review last year, as the government raised concerns about the 'quality and quantity of investment research produced in the UK as compared to other jurisdictions', which it said could in turn undermine valuations and make the UK a less attractive place to list, and make it harder for companies to access private capital.[2] The Review concluded that unbundling requirements under MiFID II have had some 'adverse impacts' on the provision on investment research, and that not all of their benefits have been achieved.[3]

"Under MiFID II you had to get the consent of the asset owner to use their money for research and as a result the vast majority of managers started funding research out of their own P&Ls. The problem was this was a huge expense and the result is they had to cut their research budgets by something like 75%, and the investment professionals and asset managers are at an information disadvantage relative to managers in the US whose funding system has not changed," pointed out Neil Scarth, Principal, Frost Consulting.

Under new research guidelines, managers can use client money for research payments without their consent, as long as they divide those costs fairly between clients, benchmark their research spending and inform clients of the method of payment. "There is an opportunity for asset managers to move this very significant cost off their P&L at a time when their margins are under pressure. This cost when transferred to asset owners is extraordinarily small but for asset managers is extraordinarily large," Scarth added.

According to Frost Consulting, asset managers pay only several basis points versus average equity returns of approximately 700 basis points per annum. But when research costs were transferred to the P&L of the asset manager, it became their second largest cost, right after staff compensation.[4] There is a market risk concern here. Frost Consulting points out that in the first quarter of 2020, markets collapsed by approximately 25% because of Covid. As a result, European asset management AUM/revenues fell by 25% and pre-tax profits for European managers fell by approximately 50%.[5] Another 2008 event could be devastating for asset managers, according to Scarth.

Moreover, there are performance concerns. Research from Evercore ISI in conjunction with Frost Consulting in 2020 showed the correlation between lower spending on external research and fund underperformance, which was significant.[6] "If you want to cut costs, this is not the place to do it. US asset owners understand that the amount being spent is completely dwarfed by these performance differentials," said Scarth.

One way for managers to address this issue is through Commission Sharing Arrangement (CSA) mechanisms, tools which can help asset managers make their budgets more sustainable.

Commission management is also important when it comes to ESG research costs, which are rising substantially. Manager spending on ESG inputs in 2020 were $2 billion, but had the potential to grow to $5 billion by 2025, according to UBS estimates.[7] These figures will only increase over time. AUM growth in ESG related assets for investment firms is expected to rise to $33.9 trillion by 2026, up from $18.4 trillion in 2021, according to PWC. With a projected compound annual growth rate of 12.9%, ESG assets are expected to account for 21.5% of total global AUM by 2027.[8]

"A lot of managers don't realise that many of these ESG inputs may qualify as research under the regulatory definition. If managers can qualify them as research in the CSA model, then they may be able to move that cost off their P&L," said Scarth.

He pointed out that there is a significant duration mismatch between what ESG funds are trying to achieve, which is carbon neutrality by 2050, and what underlying managers are paying for and trying to finance. "If there is any significant volatility between now and 2050 it will have a negative impact on manager P&Ls – which must fund the ESG spending. The time frame required to achieve ESG objectives is way longer than any historic economic cycle. We can't go thirty years without some market volatility, and managers might find it difficult to fund those ESG strategies."

Experts agreed there was a tipping point to be reached – some high profile large managers would have to pass research costs back to asset owners before anyone else followed.

Variable Costs

> All costs should be assessed in the context of value. We are seeing more and more firms come to solutions providers like us on a variable cost basis. Managers have decided for the first time in a decade that they are going to take the entire jigsaw puzzle apart, and they want to know if we can help them at every point in the value chain of decisions.

> Asset management businesses are focused much more on their primary activities around investment management. They want to retain their proven value from asset management, because that is where you differentiate yourself. But then, alongside that, they want to drive every other possible cost to a variable cost. The value chain is up for grabs for the first time in twenty years.

GERARD WALSH
Global Head of Client Solutions, Banking & Markets, Northern Trust

Key Considerations

Trade Allocation: SIFMA/ICI best practice recommendation is to allocate trades intraday and no later than 19:00 EST

Trade Affirmation: New cut-off is 21:00 EST on TD, a 14.5 hr reduction versus current T+1 cut-off

Trade Settlement: New final cut-off is 15:10 EST on T+1, 24 hr reduction

Securities Lending: 24 hr reduction in time to complete recalls

FX: 24 hr reduction in time to execute securities-related spot FX trades e.g. window post market close for AUD/USD execution closes from 28 hours to 4 hours

Moving to T+1 and the implications for portfolio management

Last year, the US Securities and Exchange Commission (SEC) announced that that it was transitioning from a securities settlement cycle of trade date plus two (T+2) to trade date plus one (T+1). From 28 May 2024, trades executed on any given day must be settled within one business day instead of two, reducing the settlement timeframe by a full business day.

Shortly after the SEC announcement, Canadian and Mexican regulators announced their own transition to T+1 would also be implemented in May. The UK, EU, and Australia are all conducting impact studies with a view to moving to T+1 in the future.

Whilst there was an expectation that pressure from industry heavyweights would delay the US regulation, this has not been the case. T+1 is something that asset managers and asset owners need to grapple with now.

For market participants the shift to T+1 poses substantial challenges and considerations that require thought and preparation. "It's definitely not just a middle and back office processing problem" explained Walsh.

T+1 impacts portfolio management decision-making, and has implications for liquidity, the cost of liquidity, cash mismatches and real time data flows. While 85% of managers impacted will be US-based, there is a balance of US$25 trillion of trade that comes from outside the US, and given the time zone differences between the US, EMEA and APAC, investors globally will be faced with a compressed settlement window.

According to Walsh, the SEC rule has introduced a tension that didn't exist before between brokers and managers. "When the US moved from T+3 to T+2 in 2017, it left loads of processing slack time in the system. There is none of that now, it is now four hours as opposed to a whole day. There are so many complications for a portfolio manager to think about. T+1 only affects you if you decide to trade a US dollar instrument, but everyone trades a US dollar instrument, and the world has to convert currencies to trade US dollars. That's the thing that will catch people out. Every basis point is precious."

Investors will feel the impact across exchange traded fund (ETF) trading, block trading, program trading, stock loan recalls and Market on Close (MOC) and Limit on Close (LOC) block orders, as well as trades across time zones.

Six Key Portfolio Management Decision-Making Considerations

ETFs

To complete orders, market makers effectively create a synthetic basket of stocks. Behind the scenes, the market maker has to buy and sell each individual component of the order so that the investment in and out of an ETF matches what happens with the synthetic buy and sell.

This brings up liquidity issues and settlement mismatches. Not every exchange in the world is T+1, they are T+2 and T+3, and some markets are already even T+0, so market makers have to know and understand how they are going to cope with ETF flows when there is a liquidity mismatch. Now that we are moving to T+1 it throws the issue into stark focus, because the vast majority of ETFs list on American exchanges. Most of the rest of the world's market is on T+2.

While this will be less of a challenge for market makers with scale who have their own treasury functions, whether smaller, niche players will be able to cope with these new stresses remains unclear.

Block Trading

Characterised by the exchange of large volumes of securities, transitioning to a T+1 settlement period introduces challenges around settlement risk and operational efficiency. Managers often trade at scale across numerous destinations, and processing time is needed to ensure that these trades flow properly.

Nobody is concerned about the flow that goes well, but everyone is concerned about a flow that might break and might hold up confirmation of an entire trade.

Block Trade Market on Close (MOC) and Limit on Close (LOC)

MOC and LOC instructions will require more operational adjustments from firms as the US and others shift to T+1.

If managers want to get their trade done at a single price into the deepest liquidity pool, particularly in the US, that's the end of the US trading day. So there is a risk of orders bumping into heightened demand as the world starts to get to grips with T+1.

Walsh believes that managers will move away from existing MOC and LOC approaches, with brokers shifting to more modern benchmarks like arrival price, something that is commonplace in other markets, like London. "We think that firms will decide there are better ways of getting things done."

Stock Loan Recall

Walsh highlighted complexities around processes and potential market impact: "One of the things you are doing in a stock loan program is that you are signalling to the person you've loaned it to that you want it back. Generally, the parts of the industry that you've loaned it out to are firms that short, which are always looking for market signals. So a market signal that needs to be sent out twenty-four hours ahead to meet a US T+1 cycle would be a signal to a group of people that something is going on with that stock. In a T+2 environment that market signal is currently not exposed to the market."

Program Trading

Block trading's 'more complicated sibling', program trading involves executing a large number of stock trades automatically, based on pre-defined criteria and strategies. Because the trading involves investing or divesting from a number of different instruments or securities simultaneously, the process can become complicated. A more compressed settlement time increases that complexity.

"Managers will have to take care. They will have to understand what their cash profile looks like and look at any mismatch of inbound cash versus the second part of the instruction they want to do. From our own experience, it is often that one of the things that needs repairing is when an instruction to buy and sell goes the wrong way, which happens more often than you might think," noted Walsh. It means that many firms will have to review their processes - particularly when it comes to trades related to foreign exchange - for the first time in a decade. "Almost all trading will get done but the matching, clearing and settlement cycle are not being done as three discrete activities, but as one single lifecycle."

Back-to-Back Trades Across Time Zones

Liquidity is another issue that will have to be addressed, as back-to-back trades across time zones become more challenging. "For a lot of the world, when the market closes on a Friday in New York, it is already Saturday morning," pointed out Walsh.

It means there is a rush to trade before markets close, and liquidity in the US dollar experiences a sharp decline from 1pm on Fridays. At 4pm, when NASDAQ and NYSE markets close, an hour of FX trading remains, and in that period liquidity is more constrained than at any other time of the week globally.

"There's always a prefunding solution but somewhere you've got to get the capital, you've got to get someone to give you a big overdraft because individual actors within the settlement cycle need to have cash in the bank account. At scale, that would be costly and it is a performance drag. Nobody wants to be prefunding the entire US dollar trading that they do because it's so much bigger than any other proportion of trading that you are doing," explained Walsh.

Wider Implications

US managers who do a lot of bond trading may also have challenges, because all bonds are moving to be on the same settlement cycle as US Treasuries, which are already at T+1, Walsh also said. "Lots of firms do use a lot of international bonds in their portfolios. If they are using US corporate bonds or municipal bonds they need to think through this whole process themselves."

Ultimately, the managers who will be least affected by the new US T+1 settlement cycle are those that do US dollar-based trading in a New York time zone, without any foreign exchange component, as Walsh pointed out. For the rest, in every market in the world, T+1 settlement cycles are the future, and preparation will be key.

> "This is a clear portfolio management issue, and there are at least six portfolio management decision-making considerations, particularly when you approach the end of the week in any market that is not Wall Street or in the New York time zone.
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> **GERARD WALSH**
> Global Head of Client Solutions
> Banking & Markets, Northern Trust

[1] https://www.namepepper.com/chatgpt-users

[2] https://www.gov.uk/government/news/new-chair-appointed-to-drive-forward-edinburgh-reforms-investment-research-review

[3] https://assets.publishing.service.gov.uk/media/64a838381121040013ee6522/UK_INVESTMENT_RESEARCH_REVIEW_-_RACHEL_KENT_10.7.23.pdf

[4] https://b0bb1e66-51c9-4555-9ca6-485a1ad3ff51.filesusr.com/ugd/610488_dd106edcf34e42b8afd35e7d723aa4ff.pdf

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