What do the latest technology trends, the evolving role of alternative investments and liquidity management actually mean to your business? At its recent annual Nordic conference Northern Trust, the global asset servicer and asset manager, honed in on key innovations driving rapid change in the financial industry around the world.

Digital disruption in the financial industry is moving fast. Last year the total investment in financial technology (fintech) from venture capital (VC) firms exceeded US$12 billion. That’s more than a 100 per cent jump compared to 2014 and a record year for VC-backed fintech investments. Meanwhile financial firms are facing significant challenges globally due to emerging technology: new entrants and disrupters, multiple regulations – coupled with client demand for new and cost effective products and services.

“This could be spring, summer, autumn or winter depending on where you are in the value-chain and obviously the interest for fintech strategy has grown significantly over the past few years”, says Justin Chapman, global head of market advocacy and innovation research at Northern Trust. Around one billion of the US$12 billion has gone into blockchain, one of the most talked about technological breakthroughs over the past years. The technique behind blockchain is complex, but the overall principle is easy to understand. Blockchain actually wipes out the need for a middleman in a monetary transaction and makes it possible to move the transaction value directly from one account to another instantaneously.

The implications for the whole financial sector could be vast. “If we were starting at zero, we would not invest our industry as it looks today with the technology that’s now available. Our industry is full of layers built up by products and services developed over the years”, says Justin Chapman. “This complexity makes it hugely important for industry participants to collate as they respond to continuous technological and regulatory change. For example, we work with the EU Commission and the European Markets and Securities Authority (ESMA) and, as part of our wider industry collaboration, with think-tanks and academia such as Harvard Law School and the Taurang Institute to work out the data science behind technology changes. We also work with fintech companies to incubate ideas as we look at implementing solutions. If we have an inefficient market with layers that we don’t need, then we should be a part of addressing this. And that results in a number of new opportunities to create value for clients.”

Evolving Role of Alternative Investments

New technology may be the most disruptive driver for the financial sector but another important driver is the role of alternative investments in a low growth, low interest environment at a time when people need to save more to fund longer retirements. “Clearly this poses a significant challenge for investors and where alternative investment comes more into focus”, says Paul Cutts, head of alternative asset services EMEA at Northern Trust. “Of the US$6.2 trillion client assets currently serviced by Northern Trust, about one-sixth are alternatives. If you look at the statistics it’s quite extraordinary, for example the number of pension funds today seeking to invest in alternative investments is something we’d never have dreamt of ten years ago. In some markets it’s close to 25 percent of the funds’ allocation.”

Key drivers behind that interest are a search for higher yield, but also lower volatility, and a hunt for uncorrelated assets such as timber and brand royalties. However there’s always a potential risk due to the illiquid nature of the assets. “From a practical perspective the management of liquidity is really important. One of our tasks at Northern Trust is to help our asset owner clients to monitor and measure that liquidity on a forecasted basis. And as investors think about an appropriate domicile for each investment, it’s important we have a scalable and efficient structure across those jurisdictions”, elaborates Cutts.

In the long run the growing interest for alternative investments underlines an even more significant change. “For custodians, I think servicing alternative investments will be the biggest change we’ll see over the next few years to our business model – and we’re seeing it already. You won’t just custody these asset classes, you will effectively provide a full middle office service: obtaining and reconciling valuations, outsourced due diligence, validate fees, all the way through to transparency, governance and customised cash investment solutions”, concludes Penelope Biggs, head of corporate & institutional global marketing and strategy, and head of institutional investor group EMEA at Northern Trust.

The Liquidity Management Conundrum

Another vital aspect of liquidity is the unintended consequence of changing regulation and market dynamics on short-term cash management. This is prompting investors to think about how they can maintain enough operational cash to settle obligations, and when holding more cash how they diversify investment exposure and manage counterparty risk.

“Central clearing and bilateral margining requirements for investors trading in derivatives mean investors need to hold more available cash or be able to generate cash at very short notice to avoid forced closure of contracts”, explains Steve Irwin, senior liquidity product manager at Northern Trust. “However investors are likely to see rates paid on deposits or even banks’ appetite to hold cash balances decrease as a result of Basel III. And finally given the low, and in some markets negative, interest rates investors may well find that holding large amounts of currency in reserve will end up costing them money.”

Northern Trust is working closely with its clients to develop solutions which address this liquidity management conundrum. Collateral management, segregated account structures and greater transparency in cleared derivative reporting are already in place. And many more solutions are in the pipeline, for example an evergreen deposit account structure.

“This is a solution for clients holding non-operational cash in their investment portfolios”, explains Irwin.

Addressing Conundrums and connecting the dots

“Liquidity is one of the global challenges that our clients are facing and we’re trying to connect the dots. That means working on more holistic solutions, looking at how we can bring ideas and services to clients as a package that will help enhance performance for their organisation. This also involves identifying synergies and similarities between different sectors, for example the insights from supporting a sovereign wealth fund investing in timber in New Zealand could be relevant for clients in other sectors and countries”, summarises Penelope Biggs. “In a way we have moved so far past ‘custody’ of this asset class it is almost irrelevant. We have to do it well, but it’s how we are going to serve the middle office for all investments that is going to set our clients and Northern Trust apart.”