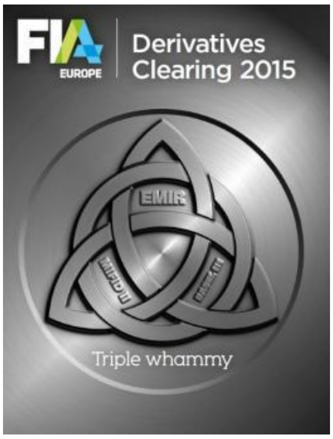

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Re-imagining Brokerage

Pressures on brokerage businesses have been all too apparent since 2009 and they face yet more regulation. But there are silver linings in these clouds. By **Nicolas Breteau**

Following the 2008 financial crisis, the 2009 G20 summit in Pittsburgh addressed over the-counter (OTC) market risk by determining that all standardised OTC derivative contracts should only be traded on exchanges or electronic trading platforms and that they must be cleared by central counterparties (CCPs). Thus was born Dodd-Frank and the European Market Infrastructure Regulation (EMIR), which together introduced a complete re-engineering of the derivatives industry. There have been many casualties as a result, both banks and brokers, but is the story entirely bleak?

The idea of pushing more market participants towards exchange traded products and practices should theoretically be music to the ears of a declining clearing industry that had been dealing since 2009 with rising costs, lower margins and falling volumes. Some new players even entered the clearing space, attracted by the potential of non-trading generated revenues. Others entered to protect their established OTC execution franchise.

Unfortunately, what happened next was not what most of them had anticipated. Regulatory demands that standardised OTC transactions must be centrally cleared severely disrupted the CCP clearing model, which ironically had proved its resilience for decades, including through the Lehman collapse. It all accelerated after the MF Global (2011) and Peregrine (2012) defaults. Those two events triggered a strong reaction from regulators, some of whom had been caught asleep at the wheel. For understandable motives they created an avalanche of post-crisis regulations that contributed to eroding profit margins and put many firms out of business. None of the regulators wanted to appear soft and after decades of relatively laissez-faire oversight, they scrutinised every part of the execution and clearing operational chain. Key among the regulations affecting the futures commission merchants (FCMs) were the Basel III rules, gradually implemented to rectify the perceived shortcomings in capital adequacy. Those rules sought to address presumed weaknesses in the market by increasing bank capitalisation, reducing liquidity risk and constraining leverage.

While the full implementation of the Basel III regulations is not due until 2018, banks are already under pressure to conform to the new standards. They now report new ratios to regulators, and their investors have been keen to understand how the adoption of the Basel measures will impact their profitability. The clearing divisions of banks, quite naturally, reassessed their business in light of these new capital measures. They took swift action because as their capital buffers increased in a flat-to-declining revenue environment their return on capital fell. They focused on bolstering capital, cutting costs and reducing lower-yielding risk weighted assets. In this rationalisation process banks made strategic adjustments to their portfolio of businesses activity and several divested capital consuming activities such as prime brokerage, commodity financing and clearing more generally. Regulators genuinely believed that their rule making, in particular Dodd-Frank and EMIR, would increase competition and facilitate the arrival of new entrants in execution and clearing. But in practice it accelerated the reduction in the number of FCMs. On the OTC side, the expected transition towards a clearing regime did not benefit FCMs handling swap trades and several new entrants exited the space, sometimes after investing heavily to build their back-office capabilities.

Decrease in revenue

Last but not least, non-bank brokers suffered from a tangible decrease of their traditional revenues from banks and many, not having scale, were unable to cope. Several disappeared and others are supposedly for sale today, contributing further to the consolidation of the brokerage industry. But worse is to come. The leverage ratio, due in 2018, appears as the ultimate nail in the coffin. It does not necessarily reflect properly the treatment of client margin by FCMs and penalises those who are collecting the largest deposits from clients to cover their exposure. Exchange and CCP leaders have quite rightly alerted the regulators. Left unchanged, the leverage ratio will drive more banks out of the clearing business. The impacts to the real economy would be significantly negative as it might concentrate central clearing responsibilities in the hands of possibly less than five clearing members, hence limiting hedging opportunities for end-users and creating a higher systemic risk.

In addition, the breadth and complexity of the Markets in Financial Instruments Directive (MiFID) II creates some new dimensions in comparison with previous regulations. The extension of the scope of the transaction reporting and transparency regimes, and the additional data requirements that arise, will considerably increase the complexity of reporting for a number of organisations.

The creation, collection and management of data and the systems architecture required to address MiFID II implementation will challenge many firms. Adding to this complexity, regulatory changes to force OTC transactions to migrate onto new platforms favoured the launch of numerous swap execution facilities and organised trading facilities. They offer more choices for clients but fragment liquidity and increase complexity for the FCMs who are facing the difficult choice of which to connect to without knowing which will survive. Moreover, a European Securities and Markets Authority paper refers to linking pre- and post-trade risk systems to achieve a real-time credit view of your counterparty risk for specific clients. This will continue to push the need for more costly investments in technology for brokers.

This level of complexity will continue to push an unprecedented transformation of the industry. Clearing used to be about processing more volumes at marginal cost. It is now the art of managing scarce resources (liquidity and balance sheet) while running with the lowest cost base possible. Clearing banks are taking action because in the current environment their return on equity of their clearing division appears to be below the long-term cost of capital (widely considered to be 10–12 per cent). Over the medium term, clearers will need to find ways to meet acceptable return-on-equity targets, or potentially risk alienating their investor base.

Not solely compliance

As a direct consequence, the work to implement MiFID II is not solely a compliance issue. Many players are making it a business change initiative that will give them the opportunity to save or at least minimise costs structurally. Instead of just making each piece of their business compliant they are looking at their organisation, product delivery and governance and are taking major steps to profoundly change their infrastructure and how they work with clients. Technology is at the forefront of this. Outsourcing post-trade cleared derivatives processing is now a reality. As the service is highly commoditised and provides little differentiated value to each firm, many of them see this as a source for substantial savings. SunGard's outsourced service for handling post-trade functions in the listed derivatives and swaps market might sound like a credible solution. Barclays is the first customer and other FCMs are said to be following its lead. Other technology providers might come into this space and several clearers might decide to contribute to a post-trade utility if they could put aside their differences.

In a similar move, several banks are teaming up with technology provider SmartStream to create a new company 'SPReD' (Securities Product Reference Data) that will pull together clean streams of reference data primarily on listed derivatives and equities.

Blockchain potential

Thinking further forward, several clearing banks are looking at the potential usage of the blockchain and distributed ledger systems in their model. Initially considered for international payments, this technology could be extended to the settlement of financial instruments. Proponents say that collateral could be moved around the system faster, to meet regulatory requirements, and that a ledger updated in minutes could save millions in collateral and settlement costs, including banks' expensive back office systems.

Clearers are also revisiting their approach to clients. Regulatory reforms are pushing banks towards more traditional activities. More liquidity has to be available to comply with stress tests. As a result, banks in the future need greater cross-selling and operational intimacy with their clients to retain sufficient liquidity for the stress test.
Banks have to have activities that are complementary to the traditional clearing service. For example, collateral management services, which once sat within niche or targeted product lines, are now at the heart of the modern FCM business model that brings agency execution, clearing and collateral management together into one service. Clearing is also increasingly being seen as a finite resource offered mainly to select clients that are valuable to the brokers, who are now looking at the total value of the client business holistically. They define the value of the client portfolio from their own perspective: different assets may vary in their value to different clearers because certain clearers may be better positioned to internalise certain asset types, for example. Although tougher market conditions and an unstoppable wave of regulation have caused several FCMs to leave the business, a renewed focus on profitability will leave survivors in a good position. The clearing industry is beginning to see the positive results from restructuring and innovation and looks well positioned to benefit from a market upturn. Pricing will pick up in the end. Regulation has forced banks to pull back in derivatives and left a few very large providers supporting an entire market, which could mean less customer choice and higher fees. And other revenues may emerge. Some large brokers are projecting their business into the digital age. Gigantic volumes of transactions in various asset classes, combined with increased automation in their processing, provide access to comprehensive, timely and accurate client and market data that some are already looking for ways to monetise.

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