Summary

- Regulatory reforms are driving change in OTC markets across all regions
- Banks have an opportunity to generate revenues from electronic OTC trade execution
- Existing client relationships are under threat
- Execution is key to achieving returns from investment in OTC clearing
- Clients will select banks based upon market coverage and pricing
- Up to 90% of OTC credit and interest rate trade volumes are expected to move to electronic execution by 2014

Point of View

This point of view is part of an ongoing Investance research initiative into regulatory change impacting the global financial services industry.
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Point of View

The SEF way to bank revenues

Banks are gearing up to explore new revenue opportunities from Swap Execution Facilities (SEFs) and Organised Trading Facilities (OTFs). With OTC derivatives clearing now established, electronic trade execution has become a priority and will soon be mandated under Dodd Frank and MiFID regulations. First movers can seize market share via providing deep liquidity to the newly fragmented market and winning business with best pricing, in order to offset the new costs of clearing and regulatory reporting.

Introduction

Over The Counter (OTC) Derivatives markets are under assault from all angles. Regulators, investors and academics agree that the market in its current form poses a systemic danger to society overall. Mandating electronic trade execution for OTC derivatives aims to bring pre-trade price and size transparency. However for banks this is an immediate threat to their client relationships and market share. Today OTC business is won based upon relationship strength, research, advice and creditworthiness. With SEFs and OTFs in place this will change; clients will differentiate banks on the pricing and quality of their end-to-end execution and clearing services. There are many challenges to the OTC markets at present, including product liquidity and regional regulatory variations, however if SEFs and OTFs can become an effective mechanism for price discovery then banks need to quickly innovate in order to protect their derivative franchises in this new environment. First movers can reap the benefits of maintaining client relationships and the scalability of a low-cost trading environment, beating new entrants to the markets.

Market Evolution

The OTC market is rapidly evolving with regulatory reforms as the driver. Dealers have already invested heavily in OTC clearing however attracting client clearing business but generating revenues from clearing is proving challenging. The third party costs involved from CCP infrastructure firms and middleware along with additional internal processing effort are placing downward pressure on profits. The business case is that banks can achieve revenue growth from collateral transformation activities due to the new margining obligations for CCPs, however many are encountering practicality issues with executing small repo sized deals and seeing their collateral rehypothication revenues threatened. It is increasingly apparent that banks need to prioritise efforts on execution in order to drive client business through their clearing capabilities. Beyond the top tier banks, many dealers have not yet invested in client clearing; for these firms having an execution-led strategy from the outset is an opportunity to recoup clearing investment in a shorter timeframe.

It is increasingly apparent that banks need to prioritise efforts on execution in order to drive client business through their clearing capabilities

The emerging OTC landscape is beginning to look similar to the listed derivatives markets. Standardised OTC contracts will be executed electronically on SEFs or OTFs and then centrally cleared with CCPs. Due to varying levels of product standardisation we expect SEFs to concentrate on trading Interest Rate related instruments, Credit Default Swaps (CDS) and Equity Swaps on broad indexes. For infrastructure providers this is a great business opportunity and to date over 20 organisations have applied for licences to become a SEF. These include existing exchanges, interdealer brokers and even start-ups such as Javelin Capital Markets, Odex and the Eris Exchange. Some infrastructure firms already have exchange offerings for OTC derivatives which can be quite quickly adapted to meet SEF or OTF definitions. Examples include Tradeweb which provides multi-dealer to customer execution for OTC rates, credit and equity options and MarketAxess which has provided multi-dealer electronic credit trading since 2001. Prior to the Dodd Frank Act and MiFID, demand for these offerings was subdued due to concerns over transparency causing information leakage, price impacts and risks of front running. This will change with the mandatory regulations and implementation dates looming in 2012. The number of proposed offerings suggests that liquidity will be split across multiple platforms and multiple SEFs and OTFs will compete with some specialising in certain products and markets.

The emerging OTC landscape is beginning to look similar to the listed derivatives markets

Figure 1 highlights that in June 2010 over 80% of all OTC deals were executed by voice with the remainder mainly accounted for by single-dealer electronic platforms. Investance sources show that there are at least 20 applicants for SEF licenses. Assuming all infrastructure offerings receive authorisation, and based upon the timelines of the regulatory mandates, we predict the trade volumes to invert up to 95% of OTC interest rate deals and up to 90% of OTC credit deals being executed over multi-dealer electronic platforms by June 2014.

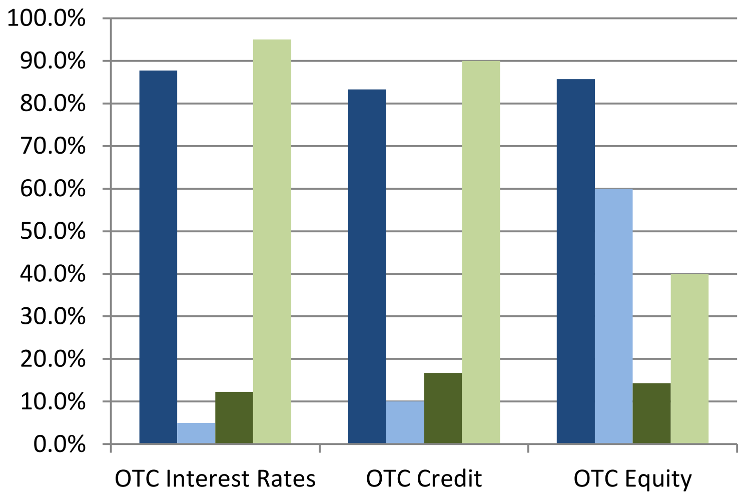

Figure 1: Monthly turnover by method of execution for all venues (bilateral & multilateral) for OTC Derivatives - June 2010 and June 2014 estimate

Source: IOSCO Report on Trading of OTC Derivatives, February 2011 and Investance Research

Challenges

Most electronic execution of OTC derivative trades today is through dealer owned dealer-to-customer execution platforms such as Deutsche Bank's AutoBahn and Goldman Sachs' RediPLUS. The view from the CFTC has already clarified that proprietary dealer-to-customer electronic execution platforms are excluded under the definition of a SEF, this approach is expected to be followed in Europe. Hence revenues from these systems are under threat and banks need to consider how to adapt these offerings to comply with the regulations. For single dealer platforms to comply, banks must either develop these into price aggregators or sell a stake in these platforms, enabling them to comply with SEF rules via streaming quotes from multiple sources. Banks could alternatively choose to outsource the relevant parts of their single-dealer offering to SEF or OTF provider in order for it to become compliant.

Proprietary dealer-to-customer electronic execution platforms are excluded under the definition of a SEF

In addition, there are some practical complications arising from electronic execution. Trading OTC products under a listed derivatives business model will involve high trade volumes, smaller notional sizes, standardised instruments and a large number of market participants interacting directly with SEFs and OTFs. For banks this threatens the revenues currently enjoyed under the OTC bilateral model. Today they can realise substantial bid-offer spreads and it is common practice to accept execution risk on behalf of their clients, holding large trades for a number of days and carrying exposure before hedging. An implication of pre-trade size transparency is that dealers will need to hedge immediately; this will necessitate smaller OTC trade notional sizes and higher trade volumes.

Modalities of execution on SEFs and OTFs are likely to vary and include order book, requests for quotation (RFQ) and hybrid propositions. The order book process is predominant in the listed markets and involves dealers providing quotes first, then the SEF or OTF showing the best prices. The RFQ model involves users deciding what they want to trade including any bespoke features and a selection of market makers providing quotes. Initially for OTC markets we expect hybrid models, based on RFQ but allow some use of voice to tailor the product and terms to be predominant. From the outset the lack of product standardisation is impeding a shift towards the order book model. A further challenge is the concept of 'last look' where dealers can validate the decision and perform credit checking before executing the trade. Experience from the listed markets suggests that over time as the market matures the modality of execution will move towards an order book model. This is likely to take a few years due to a current lack of OTC product legal standardisation with uniformity on product terms, ancillary contract terms, product definition, risk management and operational standardisation of valuation models. However we are already seeing the formation of market working groups such as the OCC forum on Equity Variance Swaps to address these issues.

Opportunities

1. Providing superior market coverage

Banks will need to connect to multiple SEF and OTF infrastructure offerings, since liquidity will be fragmented with many organisations applying for licences in anticipation of the surge in OTC electronic execution volumes. SEFs and OTFs will be in competition and are expected to rapidly on-board new products once the regulatory mandates and implementation dates are finalised. To satisfy client expectations, banks need the capability to respond quickly and adapt their liquidity offerings. Establishing these connections will be a challenge and from a technology perspective it is unlikely they will be plug-and-play. Detailed preparation and infrastructure investment is required to build a connectivity layer sufficiently flexible to support the various messaging protocols across regions and asset classes. OTC asset classes lack the unified communication protocols which exist for listed markets, for example financial information exchange (Fix) and FastFix. It is possible that these can be adapted, or banks may develop a gateway to translate

SEFs and OTFs will be in competition and are expected to rapidly on-board new products between the different communication protocols used by SEFs and OTFs for example using ION trading or competitor products.

2. Two stream execution revenue model

Having established connectivity, to maximise revenue generation banks must realign their trading business to a two stream OTC execution model; providing an agency service to find best liquidity and market making to win the business based on price. Banks can compete via aggregation and routing expertise to win commission revenues, especially once streaming prices become more available to enable SEF and OTF aggregator tools. These will create the ability to collect, compare and standardise prices, banks can then build functionality to receive client orders and a smart order routing mechanism to place trades. This means that the bank can provide clients with an integrated view across the market to secure best prices and can relieve them of the connectivity burden and operational complexities involved with multiple execution venues. In addition to external aggregation, building a system to pool OTC liquidity via internal crossing networks will enable banks to execute client orders against their own desks before routing them to the external market, hence winning market making revenues in addition to providing liquidity. Commission is a new concept for OTC markets, however if clients can access all OTC derivatives liquidity via a single entry point from their bank, they will have no need to execute via any other mechanism.

To maximise revenue generation banks must realign their trading business to a two stream OTC execution model

3. Competing via best execution prices

Since banks will be forced into mandatory competition with transparency for every cleared deal they will need to compete on execution prices In addition to providing liquidity. With streaming prices from market makers and a centralised source of market data, developing algorithms becomes possible. These will allow automation of discrete strategies to reduce the cost base and attract volumes, reducing the focus on price, and facilitates additional value added services such as breaking up large orders and executing them over a period of time to minimise market impact. This example is of particular importance given the concerns today over OTC trade size transparency, where an informed market may cause the price to move against dealers before they can effectively hedge their position. Also with greater availability of pricing data comes the potential for high frequency trading and arbitrage opportunities which will represent significant new volume flows in the OTC markets.

4. SEFs enabling cost reductions

Operational cost reductions are another immediate opportunity for banks from their OTC electronic execution strategy. SEF and OTF processes will feature immediate affirmation and confirmation along with pre-approved position limits, arrangements with CCPs and reduced processing complications and client queries. There will be operational efficiencies and cost synergies between firms partnering to offer execution and clearing, for example the London Stock Exchange and London Clearing House have such plans. Connecting to multiple SEFs will remove dependencies upon middleware such as Markitwire and ICElink for affirmation and routing, thus reducing third party costs and operational complexity. By realising process efficiencies, banks can realign staff towards bilaterally traded business where bid-offer spreads will be wider. In addition with similarities arising between OTC and listed derivative operations, possibilities arise for cross-product integration of operational services and IT architecture. For banks internal processes the new execution capabilities will need to be integrated into clearing and settlement systems and operational processes adjusted. To launch this process and make it scalable will involve significant investment in front-to-back technology.

5. Enhancing client relationships

Cementing OTC client relationships in the new environment from the outset is critical. A recent OTC buy-side survey conducted by Investance revealed that clients find the changes to the OTC landscape daunting and are concerned about costs. Enhancing the client experience and meeting their expectations will be paramount to retaining their business and many clients are intending to deal with fewer banks in the new more complex environment. It is also worth noting that with credit risk mutualised via central clearing this will be less of a differentiator for banks trying to win clients' OTC business. The first banks to establish capabilities such as a market leading user interface and fast processing will gain clients' attention and retain market share. Another reason for banks to respond quickly is that barriers to entry will erode over time with consolidation of SEFs and OTFs, also product standardisation reducing processing complexities. New entrants are a threat and the listed markets have seen significant disintermediation with infrastructure providers enabling direct execution with retail participants and with legal barriers and reliance upon ISDA master agreements reduced.

Many clients are intending to deal with fewer banks in the new more complex environment

Conclusion

OTC markets have already begun a journey towards a fast-paced commoditised world. To date banks' efforts to define an execution strategy have been hindered by regulatory ambiguity as the CFTC, SEC and European regulators struggle to interpret the statutes. However this environment is rapidly evolving with the implementation of regulatory mandates now in sight. Taking a wait-and-see approach will put banks' derivative franchises at risk; experiences from when the equity and foreign exchange markets moved to electronic execution suggests that market share will concentrate amongst a few key banks. It is expected that voluntary industry targets for OTC electronic execution will soon be discussed and those banks well positioned will enjoy growing market shares. The OTC markets have reached a turning point and by 2014 the majority of dealer-to-customer business will execute electronically. Many banks can take advantage of their global footprint, existing listed derivative systems and technology development capabilities around clearing to respond quickly and grow market share.

Taking a wait-and-see approach will put banks' derivative franchises at risk

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