



FUTURE OF DERIVATIVES CLEARING



Broadridge®

EXECUTIVE SUMMARY

The futures world has changed. This is no surprise to anyone in the business dealing with the ongoing rollout of global regulations, low to negative interest rates and the need for all banking businesses to wisely use capital. The effects of these changes can be seen in the reduction in the number of FCMs (see Figure 1) and the retrenchment of remaining businesses along asset and geographic lines. The competition to attract and retain profitable business has never been higher.

FIGURE 1 Number of FCMs as reported by the CFTC¹

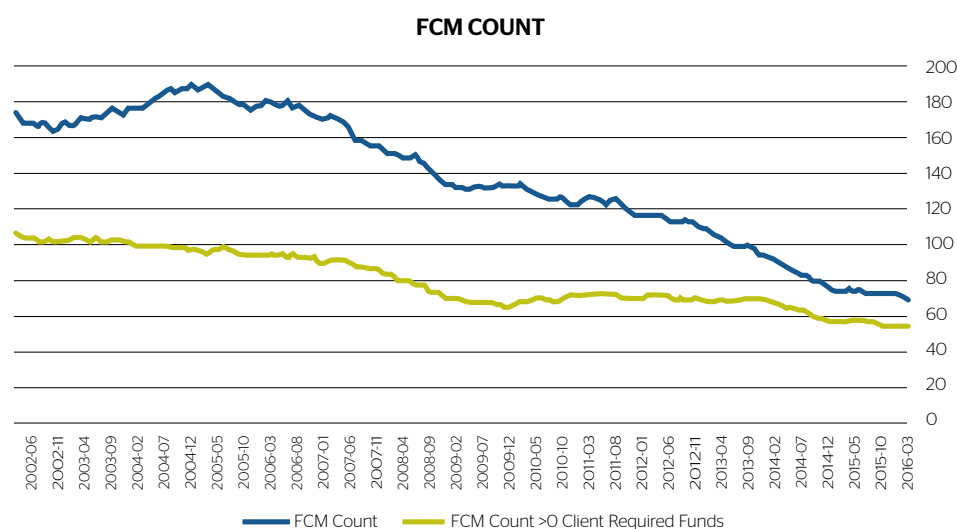


Figure 1: Number of FCMs as reported by the CFTC¹

The futures industry has to overcome its past to have a positive future, whilst dealing with the challenging present. Demands are greater across the board – from clients wanting better, more timely and more transparent services; regulators requiring more transparency and demonstrations of business control; futures clearing businesses being transformed into full-fledged derivatives clearing businesses that include complex OTC derivatives; and bank management critically reviewing all business lines for capital stewardship, profitability and viable long-term cost structures. No one can survive, or thrive, by applying the same methods and solutions in trading, operations or clearing to a future where revenue growth is not enough and strategies continue to move in a cross-asset direction. The days of independent silos have ended.

Derivatives clearing businesses have to be on a new path. Post-trade is the area where change can have the greatest positive impact for an FCM. The greatest gains in performance, transparency, control (operational and cost) and customer service all come from addressing the current state of post-trade – moving to operational models supported by technologies commensurate with the front office.

INDUSTRY BACKGROUND

ETD has been its own unique business silo within banks. As such, it has been driven by its own modes of delivery (technology and operations) to customers. Clients have come to expect a high performance, scalable, real-time (microsecond and millisecond) response to needs and deployment of the latest technologies and algorithmic complexity to execute refined investment strategies from trading desks.

The front office is an exemplar of adoption of, and adaptation to, the latest innovations in computing technologies across all industries, not just financial services.

Then post-trade experiences and expectations arrive. Batch processing, manual interventions (even for trades without exceptions), lack of immediate transparency on trade statuses with FCMs and CCPs – all increase the costs of service for FCMs and reduce the ability to make the best possible decisions based on current positions and lifecycle statuses by the FCM and their clients.

Customer expectations have been driven by this long-term state of service. It is an environment built with the expectations of ever-increasing revenue streams, versus a focus on profitability. In a more benign environment, these characteristics can, and have, survived. But the environment has changed. Customers are implementing ever more in the way of complex multi-asset strategies – exposing them to different service models within each FCM organisation they deal with and expecting the highest levels of service across the relationship. This is especially true as OTC markets move to a cleared model.

Customers expect better service across all aspects of their lives, professional and personal, and are not going to continue to accept the ‘way it has worked’. Neither do regulators nor bank management. Customer service must increase, whilst meeting the expectations of regulators for controls and transparency within post-trade operations. Management expects the best use of capital and profitability.

FIGURE 2 Regulation has brought stability to financial markets...

Since the 2008 financial crisis, how has new regulation affected the stability of the global financial system?

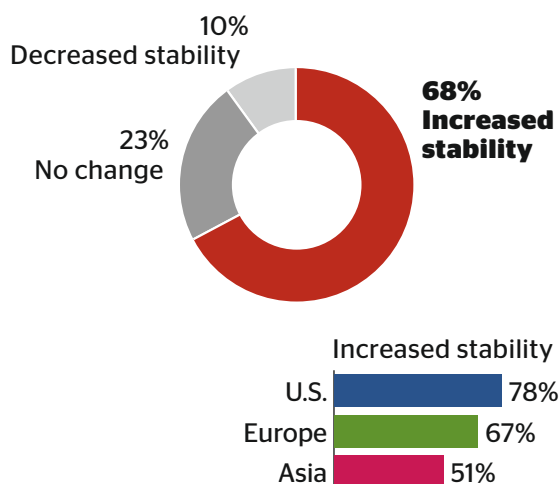


FIGURE 3 ... but regulatory pressure on global securities firms will intensify over the next five years.

Over the next five years, how will regulatory pressure on global securities firms change?

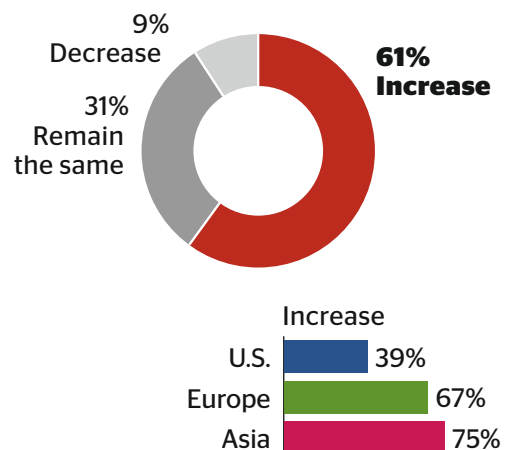
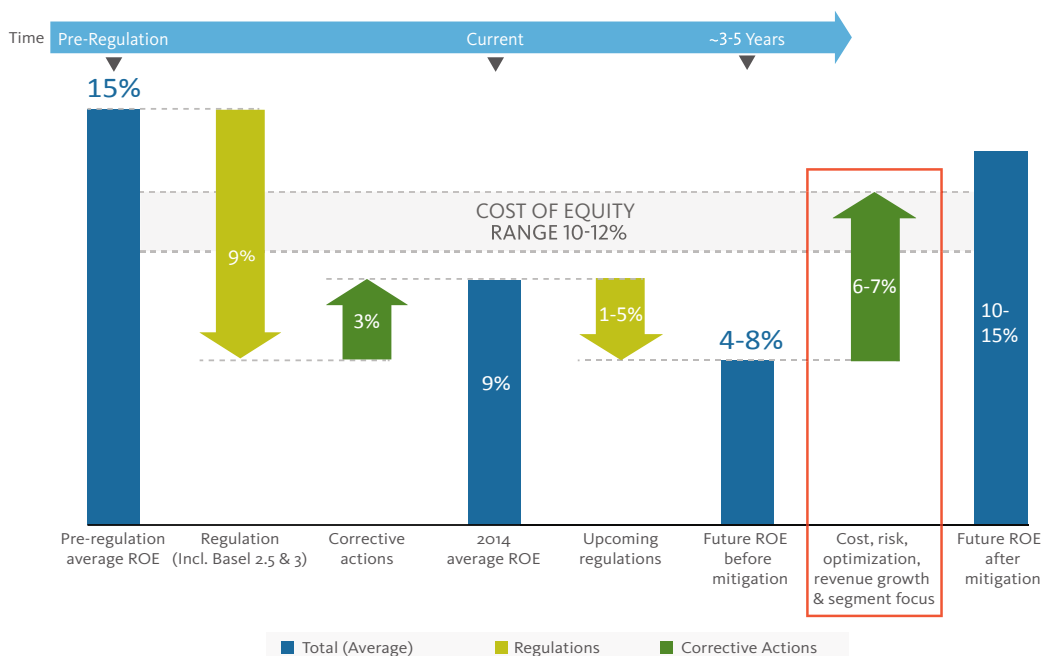


Figure 2/3: Regulation has brought stability to financial markets, but regulatory pressure will intensify²

No business line is immune to deep scrutiny. As we have seen with business exits across derivatives and other banking business lines, if the customer logic, profitability and efficient use of balance sheet are not there, even long-standing revenue generating businesses will be scaled back or shut

down. Derivatives post-trade management cannot escape this logic – evolution and change are non-negotiable. The question is what type of change will best enable the shift from today’s cost structures and service models to a sustainable path for derivatives businesses.

FIGURE 4 Effect of Regulation on Return on Equity (Pre-registration to 2020)



Source: Broadridge analysis; BCG, McKinsey

Figure 4: Effect of post-crisis regulation on ROE (pre-regulation to 2020)³

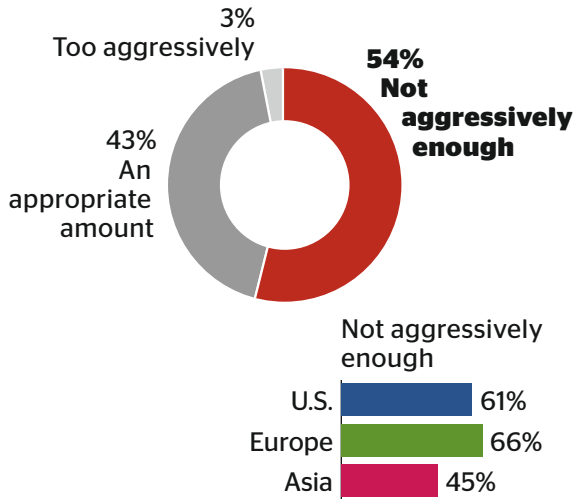
DERIVATIVES CLEARING: THE NEW PATH

The customer must be put at the heart of post-trade operations. Clients and the traders serving them need to know not just the pricing risk of a trade, but also the clearing risk at the time of trade. Receiving post-trade data – positions, clearing status, open trades, margin (including currency) exposures – in real-time – becomes critical to making the next trading decision. If the clearing or any of the post-trade status updates gets delayed by minutes, then that risk is not dealt with and strategies may unravel. This becomes far more significant in the derivatives world where the notional value of the trades is very high compared to cash instruments.

The client, whether a buy-side investor or proprietary trading desk, must have visibility across all derivatives classes – ETD and OTC – of clearing statuses with CCPs. For this visibility to be real-time it cannot depend on the phone or email – mechanisms such as real-time portals and APIs must be available for the customer to see current statuses and use that information to make the best trading decisions. But the flow of information cannot be one way if FCMs are going to offer the best services and be able to give the most accurate information to their clients. Where a portal or API is given to a client to receive status, they must use it to provide key information such as allocations or preferred close out approaches to the FCMs in real time. Providing these self-service mechanisms, and ability to ingest data into FCM systems real-time, is a critical part of deploying real-time information delivery to customers.

FIGURE 5 Analysts believe banks have underinvested in technology and process improvement to control costs.

Over the last five years, banks have invested in new technology to improve efficiency and margins...



Over the last five years, banks have re-engineered their business processes to improve efficiency and margins...

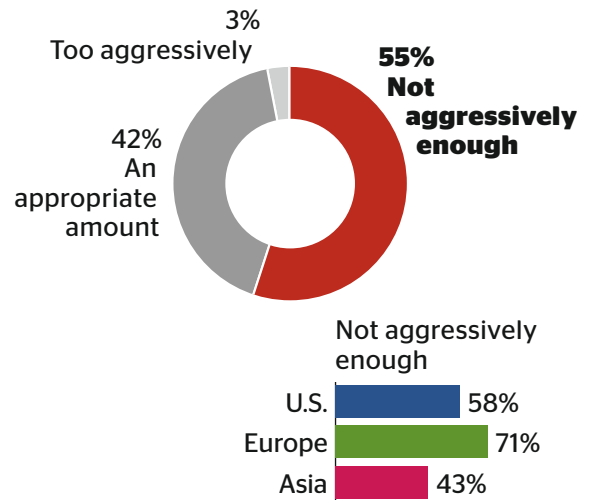


Figure 5: Bank technology and reengineering analysis²

Operations models across all asset classes have been moving to exception based processing and the use of proactive workflow management. If operational staff is inundated in a sea of normal-course trades to review, they cannot be responsive to client requests, nor can they focus on the highest priority items, as these become hard to find. To provide real-time responsiveness and controls, derivatives operations must be focused on exceptions.

This processing has to be centered on the customer – SLA-based and focused on strategy enablement. Achieving this requires a rules-driven approach to issue identification, prioritisation, escalation and resolution. Common exceptions need to be clearly identified, and where the risks are low, resolved with minimal intervention by FCM staff. Rules configuration needs to drive the delivery of exceptions back to clients for resolution, where today it would take a phone call or email – a cycle that delays the time to resolution for everyone. Real-time, rules-driven exception handling reduces the risks for clients and FCMs as issues are brought to the fore immediately and pushed to the appropriate people to make the necessary decisions to resolve them.

A real-time, exception-driven client post-trade model opens new opportunities for FCMs to better service their customers. Real-time data flows are a base from which an FCM can look to provide analytics services and new data services. Having

this kind of visibility across positions, margin and clearing states provides an opportunity for more advanced monitoring of liquidity and capital – giving the FCM the ability to better optimise capital usage for the firm and clients. Finally, the cost reduction and staff time freed by enhancing the post-trade operating model increase the resources available to support clients in adopting new trading strategies and models – maximising service and revenue opportunities.

HOW TO GET ON THE PATH

Technology is the lynchpin for getting onto the path to a customer centric, real-time, exception-driven post-trade operational capability. Technology change is the only way to increase customer transparency to a real-time, self-service driven model. And to move to a rules-driven, exception processing model, only the proper technology enablement can make this possible. This requires investment.

Typically in the front office trading areas, banks have deployed modern technology architecture to handle millions of transactions in a high-performance

environment. Equivalent investment has not been made in post-trade technologies. Investment and change are required, but there are obstacles to some alternatives. Global financial reforms (Basel-III and others) require banks to raise their equity capital and keep a very high cushion for any anticipated failures. To satisfy the stress tests required by the regulators, banks have to closely monitor their capital structure and evaluate their assets that occupy their capital. Unfortunately in-house technology assets do take up capital.

Solutions must be capital smart and cost effective. Cost effectiveness comes from using technologies that can perform the tasks required in the new world of derivatives clearing. The infrastructure must support both ETD and OTC through the full post-trade cycle – trade capture, allocations, margin, positions, settlement and clearing. And this technology must be capable of responding in ‘front office’ real-time, delivering a capability where the challenges of today and tomorrow can be met.

FIGURE 6 Technology and process reengineering hold the greatest promise for cost reduction, particularly in the back office.

Rate the cost saving potential for banks that take the following actions over next five years.

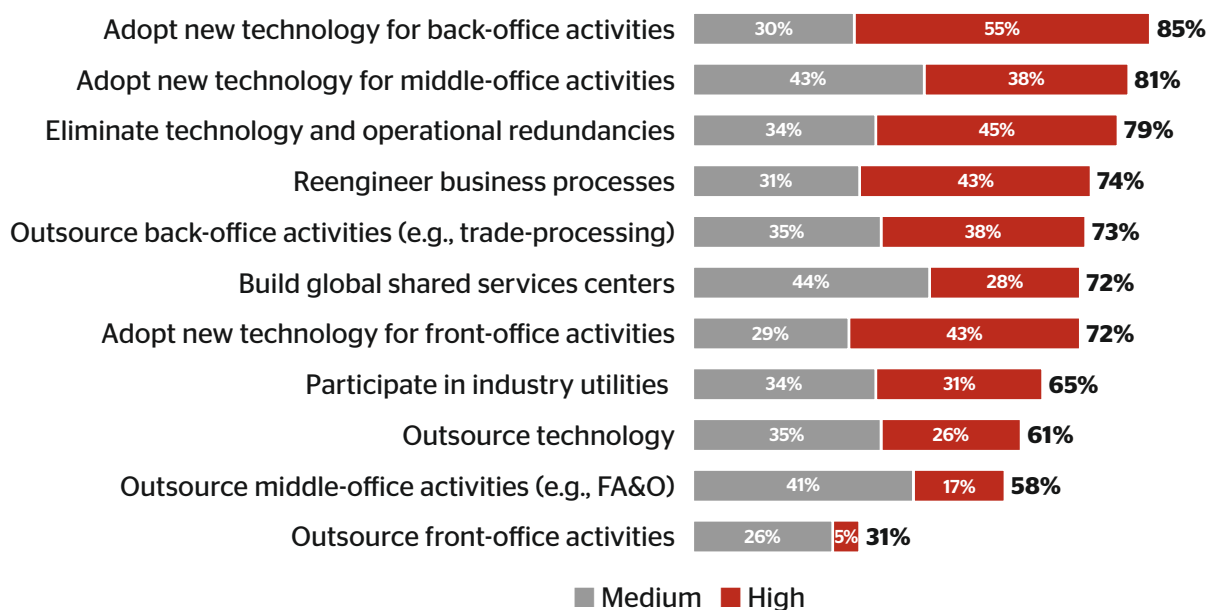


Figure 6: Cost-savings potential for banks²

CONCLUSION

Derivatives clearing businesses face the same pressures – even more so – as other banking business lines. Profitability must be increased, capital must be utilised effectively, risks must be better managed, and client service must be improved – all in the face of continuing regulatory pressure.

Post-trade technology is the key area for FCMs to focus to successfully face these challenges. As the responses of industry analysts indicate (Figure 6), investment in new post-trade technologies (across all banking business lines) is the key for banks to increase profitability and return on equity. How and where to make these investments, though, is the critical choice facing the FCM community. This is exacerbated by the variety of constraints and requirements that need to be met: the continuing roll-out of regulation; focus on profitability; and the capital constraints already in place.

The best decisions on investment in post-trade technology – to truly address cost, profitability, and regulatory transparency – will be based around the customer. How will the investment improve customer service? How will risk for the client be reduced? How will the FCM be able to offer better services (and capital usage) to their customers?

These questions are best answered by transforming post-trade technology into a set of capabilities commensurate with the front office – an area synonymous with technology innovation globally. Real-time responses and visibility, advanced self-service options, rules-driven exception capabilities, and constant access to up-to-the-millisecond data are imperatives for post-trade technology infrastructure to deliver if FCMs are to embark on a new path of business sustainability and returns to growth.

1 Chart supplied by Clarus Financial Technology.

2 “Restructuring for Profitability – Analysts Predict Opportunities and Challenges for Global Capital Markets Institutions Through 2020,” Broadridge, December 2015.

3 “Charting a Path to a Post-Trade Utility: How mutualized trade processing can reduce costs and help rebuild global bank ROE,” Broadridge, September 2015.

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