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MARCH | 2015

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WELCOME TO FIA EUROPE INFONET

"You've got to accentuate the positive, eliminate the negative, latch on to the affirmative, don't mess with Mister Inbetween."

So go the lyrics to the classic song made famous by the likes of Bing Crosby, Dinah Washington and Ella Fitzgerald. It is, of course, a noble aim; and one that many in the listed derivatives space have been trying to preach for some time, though not always with great success.

The reports from January's InfoNet event illustrate why that has been the case. It is not easy to focus on opportunity for growth when the message from all around is of higher costs, tighter regulation and more complex operations all taking their toll.

Yet opportunity abounds, not just in those markets that have not been hit quite so severely by the tightening grip of regulation and the ensuing higher costs – like Asia – but also in the fields of product and technology development.

While nobody would want a repeat of the dotcom bubble of the late 1990s and early 2000s, the growth in the fintech sector and innovation that is spurring it suggest that there is a still a market for intelligent services that provide real solutions to the market. Indeed, the more regulators put forward new obligations to be met, the more firms need to find the right kind of service that will enable them to comply with those obligations.

So, while there is no denying the difficulties that the industry is going through, the changes that are bringing about those difficulties are also full of opportunity – the industry just has to be nimble and intelligent about rising to the challenge.

Emma Davey

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A REPORT ON THE 22ND FIA EUROPE INFONET

SESSION 1: CONNECTING GLOBAL MARKETS

From left to right:
Emma Davey, Steve Martin, Virginie Saade, Johnny Aucamp, Steve Grob

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OPENING REMARKS

Steve Grob, Director of Group Strategy, Fidessa, opened the January InfoNet session on 'Connecting Global Markets' with a brief talk on globalisation, partly inspired by his Christmas reading of 'The Age of the Unthinkable' by Joshua Cooper Ramo.

Steve Grob The basic premise of the book is that the whole way we think about the global issues we face, whether that's terrorism, global warming or the collapse of the financial system, is wrong; and not only is it wrong and won't fix these problems, it's actually so wrong it's going to make them worse.

This is because most Western thinking is based on two basic constructs. The first is to focus on an objective, usually with a fairly short-term time horizon, and the second is that to understand a system you can deconstruct it into its parts to see how they all fit together and then understand the whole thing. That works pretty well for most systems, except when they get really interconnected and complicated.

This complexity was illustrated by the work of a Danish scientist called Per Bak who spent his time dropping grains of sand onto a flat surface, which eventually fell into rough pyramid shapes. Eventually a grain of sand caused a collapse on one side of the pyramid. That's called a non-linear event. It's scientifically impossible to work out which grain will cause that non-linear event and where it will happen. That's because of the interconnectivity of all the different grains of sand.

American foreign policy is a good example of how dangerous this thinking can be. Apparently it was based on research done in the 1960s which looked at all the wars that had been fought since the 18th century and discovered that democracies didn't declare war on other democracies. This evolved into the Democratic Peace Theory which aimed to export or impose democracy on any state that the US felt threatened by. The interesting thing is that from Vietnam through to Afghanistan and Iraq that policy has not only failed to solve their problems, it's actually made them far worse.

So I started to think about that pyramid of sand as the global financial system with our regulators taking it in turns to drop their little grains of sand on top without really understanding the whole thing. This led me to the idea that the chances of a non-linear event are actually being increased by the work of regulators. The book offers insight into how we should think about complex, interconnected systems. There were three points that stood out for me and I wanted to describe each one and then ponder what it means from a technology point of view.

The first one is the sense of context and looking around the near field of an object and getting a sense of what's really going on and asking the right questions.

A good example of context comes from the rise of the Cubist movement in art, replacing the photographic realism of before with something far more 3D and giving a sense of movement to what was going on. That was one of the most radical changes in the art world.

So maybe, if you want to prevent the next global financial crisis you shouldn't be regulating the finance industry but the global economy instead. Because, unless our economy is focused around credit rather than debt, then this debt will simply keep getting passed around the world in one shape or another. Replacing debt with credit is probably the only way you can make markets irretrievably safer, but of course that comes with huge political and economic ramifications.

Social media can play an important role in providing context to interpreting market data. Admittedly, systems that purport to predict prices through social media are generally not very good, but the idea of using social media to provide context so as to understand static and structured data faster and better does make a lot of sense to me.

The second point was the concept of resilience. The book draws a distinction between resistance, which is a hardwired, programmed response to a planned event, and resilience, which is much more subtle.

Looking at our markets I ask myself how we can make them genuinely more resilient. Is this achieved by putting more risk in massive individual clearing houses (as the regulators would want), or by distributing that risk across multiple venues. From a technology point of view it's the same thing. Should you be addressing global markets as a business, by having a global hub and spoke model, or should you have bunches of different regional offices that all interact?

The final concept was the ability and willingness to adapt. Things will change more quickly in directions that we can't imagine and being passive is simply not a way to deal with that. You have to be part of the change.

"Things will change more quickly in directions that we can't imagine and being passive is simply not a way to deal with that."

Steve Grob, Fidessa

Of the many reports businesses put out on their performances over the Christmas trading period, one in particular stood out for me. It was from Waterstones who apparently had their best trading period ever. How was it that a business selling something as old-fashioned as books in shops was suddenly doing so incredibly well?

The reason was simple. Senior management had allowed all the local store managers to decide for themselves which books to put on display in each store front. Suddenly each store becomes massively more relevant to its local population. It's a simple yet great example of embracing 'adaptivity'.

To put that into a technology context I began to think about the use of mobile computers. When I watch TV with my children they all have a second device. They might be playing on one of them or communicating on another. That's just the way that generation uses and consumes technology and information. And the idea that as those people enter the job market they would leave all that behind makes no sense at all. We have to find a way to involve that mobile technology in everything else that we're doing.

To draw all of this together I think most people who look at our industry think it's complicated enough already. And looking at the convergence of OTC and exchange-traded derivatives, the competition that is increasing among the major exchange groups and the differences that open access to clearing is going to make, it will get a whole lot more complicated and interconnected. My point is that those firms that can think about it in terms of context, resilience and 'adaptivity' will be the ones best placed to take advantage of it.

DISCUSSION SESSION

The January 2015 InfoNet session on 'connecting global markets' took place against a background of a spate of exchange announcements linking the US and Europe to Asian products and markets. As volume statistics show, over half of the top 30 contracts are in non-traditional, newer markets, with many of them in Asia. Although they may have a small contract size they are seeing huge volumes and are attracting both local and global participation. While many participants are connecting to these new markets in different ways using a global approach, many others also trade them from a local standpoint. Regulation also remains a major factor with some new rules potentially putting barriers in place, making it more difficult to connect electronically to markets around the globe.

The discussion began by examining how firms participating in global markets viewed their role and how they were structured to best take advantage of the opportunities. **Steve Martin**, Executive Director and COO, G.H. Financials (GHF), explains that his firm operates a hub and spoke model, with offices in Chicago and Hong Kong supported by a London hub. "The key thing is that we look at ourselves as one organism to benefit the client," he says. "We are not bothered if the lead salesman in Hong Kong closes an account that's supported in London but is contracted into Chicago. We don't worry about cross charging and swapping P&L etc. Customers just want to know that they are contracted to a counterparty in a jurisdiction they are comfortable with and the counterparty's balance sheet and level of service."

According to Martin, an important advantage of the hub model is that GHF can take a holistic view of clients' risk, regardless of the markets they are trading on. "If they're active in Montreal, ASX and Eurex, for example, we can view the risk in one place. The hub and spoke model works very well for us. GHF views itself as GHF, not GHF London, GHF Chicago or GHF Hong Kong."

Virginie Saade, Head of EU Regulatory Affairs and Execution Services, KCG Europe, describes how her firm, a global market maker and broker, came about as the result of the merger between Knight and Getco. "Originally the two firms grew organically, becoming global because investors are global with global needs and the two firms wanted to serve them at a global level. The merger set that globalisation in stone."

"Market-making is a very low profit margin business," she continues. "It's important to be global. You need to have scale for it to make sense as a business.

Increasingly for customers, borders are becoming irrelevant. They like to have local services but they want you to think globally even if you act and are present locally."

Jonny Aucamp, CEO of OSTC, describes his company's modus operandi. "We view ourselves as an international business with a very simple business model. It's a pure principal trading business. We trade the company's money and have no clients. Even that simple a business is getting much more complicated nowadays. We are different to GHF because we look at each country as its own business and let them find their own unique style. We encourage a good culture but we give them all free reign to find their own dynamics in the trading arena while we provide services, tools and connectivity from a central hub in the UK.

"We start everybody off on the major exchanges on the most liquid products. We look for highly motivated talent and you can find that anywhere in the world, often away from traditional financial centres. It doesn't matter where you trade from, especially if latency is not a major issue. The grounding we give is in traditional complex spreading strategies across the yield curve."

Steve Grob, of global technology supplier Fidessa, comments: "Historically our footprint has been in cash equities, and because they are traded on a regional basis you have to understand all the local subtleties; equities are traded completely differently in the US than they are in Japan, for example. However, the way futures are traded is much more universal, regardless of the country that an exchange is situated in. As we moved further and further into derivatives we found that we needed to adjust our own business model accordingly."

Grob also believes that the customer/vendor relationship is changing in the new environment. He tells of a new acronym which has recently entered the regulatory lexicon that underlines this view. "Everyone has heard of 'KYC' or 'know your client'," he says. "I came across 'KYV' or 'know your vendor' recently. The idea that the global FCMs we sell to must now really understand not just traditional vendor viability, but also how the vendor and its technology works, is becoming a real trend. It is an increasingly important part of our activities, and perhaps rightly so, and we're seeing ever-growing sections on resilience and data centres to be completed in the RFPs we're responding to."

BARRIERS TO ENTRY

Barriers to entry to global markets have certainly become higher over the past 10 years, according to Aucamp. "You certainly don't see the small firms that used to bring energy and innovation because the barrier to entry is scale," he comments. "You need exchange memberships coupled with the economies of scale of high volume to get a fee base that works for you to give you the margin to make profits. That is doable, but you have to work at it."

Saade agrees that it is costly and not easy to be global. "You have exchange fees and market data fees. Profit margins are reduced because the competition is very intense," she says. "Regulators want you to be extremely vigilant. You need to be resilient and transparent about what you're doing. It's a mix of things that makes you a strong global player."

Martin, on the other hand, feels that barriers to entry have come down. "Only ten years ago Eurex would not let me become a GCM because I didn't have an office in Frankfurt," he explains. "That has all changed enormously. You don't need capital in every single financial centre. You don't need capital in Paris to trade Euronext Paris or in Chicago to trade the CME. Asia is different, but even that's opening up. It is certainly expensive to become an FCM and technology is costly but capital can be used far more effectively than it is currently." He continues: "With the hub model, if you have technology linking your businesses with one machine processing your trades rather than a dozen, you can make significant savings. Significant changes have meant most markets are far more accessible and further reading changes in Asia will open up those markets as well."

Standardisation, whether with respect to regulation, technology or communications, is an important issue for market participants who don't want to have to build new processes for the US and Europe and then countless more jurisdictions in Asia. How do they manage the complexity of accessing a range of different markets?

Grob says that Fidessa tackles this at three different levels. "Firstly, at the ground level, it's about infrastructure, including venue connectivity and resilient data centres. On top of this we have a global asset class agnostic switching layer that enables us to route pretty much anything, anywhere. And then the final layer is asset class specific, and in some cases regionally specific, workflow software."

"Our role is to smooth out the wrinkles to facilitate global access to markets," he says. "We spend a lot of time and money achieving and maintaining that, but at the same time we have to ensure that we can innovate and, more importantly, make it easy for our customers to innovate, on top of these layers and that is very much about standards."

"We have also seen strong demand for the use of order routing standards like FIX in post-trade operations too," he continues. "People want to reduce the time and complexity of doing allocations and re-use the same data captured in front-end trading systems to do those allocations. Not only is this faster and cheaper, it's much lower risk as well. Many customers are starting to adopt that idea. You have to think all the way through the workflow stack."

Grob believes that the next quantum leap in complexity will come when people want to trade equivalent, but not fungible, products seamlessly. "They'll want to do that so the margin they have lodged with clearing houses is used as efficiently as possible. That's difficult because you have to decide an acceptable proxy for the main contract you want to trade and then look back at the margin positions you have on other contracts. It really will get a lot more complicated."

Martin sees the complexity but accepts it as a challenge. "Clearly, the more markets and clients you connect to, the more complex the wiring becomes," he says. "Our technology issues are about speed of

“You need to be resilient and transparent about what you’re doing. It’s a mix of things that makes you a strong global player.”

Virginie Saade, KCG Europe

change within the market versus speed of change within technology. We’re not scared of adding layers of complexity to our network. Bringing on a client in a new country adds to the fun. Technology won’t be the restrictor, but imagination might be.”

Aucamp agrees that most technological roadblocks can be overcome. “The connectivity we need is becoming more stable every day and good telecommunications lines are easy to source,” he comments. “We need good front end software. From a stability point of view we’re not hugely latency sensitive because we are traditional point and click traders. Our major focus is on staying at the top of the food chain of liquidity provision because that helps us control some of the costs that are being piled into the business right now.”

Saade’s company also trades across asset classes globally. “We are connected to more than 40 different venues, wherever our customers want us to be,” she observes. “As a market maker we need to invest heavily in technology to ensure we can renew our quotes rapidly, that they are relevant to the market and that we can bridge the time gap between the buyers and the sellers – that’s what makes our business case.”

“Brokers also need to keep up because if you want a ‘smart router’ it has to be fast enough to reach the markets to get the products customers wish to trade. If you’re too slow or inaccurate in the way you trade that can cause big problems.”

“Investment is also needed because regulators demand that you control everything that you’re doing, so you try to automate because it’s safer,” she continues. “Many things you invest in can be leveraged because things you’re doing in one country can be used in another.”

REGULATORY PITFALLS

The panel went on to discuss the regulatory pitfalls that can arise. Aucamp says his company had encountered a situation where restrictions on access had been imposed. “The local regulator deemed that we were trading on the local exchange too heavily for our categorisation of regulation in that jurisdiction and that we should stop altogether,” he explains. “We’re in the process of closing that office. It is certainly an unusual situation and not one we have encountered before.”

He went on to explain that it can be difficult, despite best endeavours, to ensure traders from different offices in different jurisdictions or even continents do not, on occasion, inadvertently trade with each other in illiquid markets. “We have developed software to alert us as and when this happens in order that this can be immediately reported to the pertinent exchanges,” he says. “This solution has been accepted by the exchanges, appears to be working well and satisfies all pertinent bodies.”

Grob feels that there is a disparity in how the rules are interpreted across different jurisdictions. “There is a wide spread between US and European markets where local competent authorities are very strict on how rules are enforced. But as you become more global, these interpretations overlap, which makes strict adherence to the rules harder to achieve.”

Martin does not wholly agree. “It’s incumbent upon everybody that accesses any market, whether as a local player or a remote player, to ensure that he adheres to the spirit as well as the letter of the rules,” he says. “Whether they’re going to beat you up about it or not doesn’t come into our thinking. It's a privilege to be a remote player on some of these markets. In some cases we're the only remote player so we try to respect their rules to the letter."

Saade agrees with Martin. "As soon as you interact with a market and have an influence on the products that are traded there you should be accountable and visible. That helps make people less worried because there is a big issue with trust right now."

That trust issue is being solved by an educational process explains Saade. "Increasingly, market participants are explaining to regulators how they go about their business. All the consultations we are having with ESMA are living proof of that. The good news is that they are actually listening. We are now at the second consultation phase and you can see that they heard what we said in the first place. I really believe they will come back to the European Commission with a proposal that will make our industry better."

The categorisation of certain businesses has also made it difficult in some regions.

Martin notes that everybody recognises his company as an FCM and understands what it does. "But we do get a different response depending on which market we talk to. For example, we approached Montreal and Sydney at the same time and Montréal said 'no' while Sydney said 'bring it on'. That's just the nature of the beast."

Aucamp observes that in some jurisdictions his company has had challenges in having his company's business model correctly categorised by the authorities as they may well not have come across principal trading businesses before. "On occasion we have had to be classified as brokers as this is the closest type of business that they can accommodate," he says. "It can slow the opening process down and be a little frustrating as it is a higher level of regulatory oversight than would normally be required for our activities but is not too detrimental in the long run."

With that sort of restriction occurring, do market participants look for regulatory arbitrage or for markets where it might be easier to trade for whatever reason?

Martin says that choice of venue is purely driven by clients. "There's no decision other than, can we get there, have we got people that want us to go there and can we make money? We have to build the infrastructure and the rules, processes and policies enable us to do that but it doesn't matter to us who we are regulated by."

"We do get a different response depending on which market we talk to... that's just the nature of the beast."

Steve Martin, G.H. Financials

He does not believe that much regulatory arbitrage goes on. "Recently, for example, we had to choose between Singapore and Hong Kong for our Asian hub. You could argue strong cases for both of them. The regulatory regime wasn't discussed at all. It was a lot of other factors."

In many jurisdictions it seems that regulators struggle to get their heads around electronic trading, electronic access and associated issues.

Saade says that KCG are not affected by this because it is a direct member of most markets it trades. "However, it does sometimes get complicated for our clients," she observes. "MIFID II says that if you are a market maker using a DMA provider, you have to be authorised. That is a new thing. Now, the regulator wants to know who your customers are and what they are doing. The French regulator has even asked Euronext Paris customers to declare if they are using algorithms."

"It also gets burdensome if you have to do something twice," she says. "Regulatory bodies want you to have controls in place as a broker but then they ask your clients to have the same controls. In the first consultation hey even suggested that DMA providers should request source codes from their customers. That conflicted with the level of confidentiality rightly expected by our clients."

REGULATORY EQUIVALENCE

The panel also discussed the ongoing regulatory equivalence discussions on clearing, and if they would help or hinder businesses.

According to Saade, interoperability is absolutely fundamental. "With respect to MIFID we should have taken care of clearing and settlement before even going into the trading side," she says. "We have fragmentation in Europe because we didn't solve the structural issues. Now we are stuck with this situation but I expect that the next steps will solve many of the issues. It's good that MiFID II forces exchanges to look at open access and to find alternative solutions for clearing because that completely changes the business case. As a broker or market maker being able to choose one clearing agent across Europe with one clearing house or one CSD would be absolutely fantastic. Then, you can really serve customers better because you can focus on what's important to them, like offering the right venues and products and investing in improved technology."

Martin is not so bullish for the prospects. "The clearing space internationally will always be fractured. You might solve it in Europe, but if you're a global business you still have to manage different regulators and rules elsewhere. We'll embrace equivalence if it comes, but we're not going to throw ourselves off a cliff if it doesn't."

PROVIDING LIQUIDITY

The issue of providing liquidity to new exchange and product launches was also covered.

Saade believes that liquidity provision is difficult at the present time, principally because the equity markets are not particularly exciting. "But as a market maker you still need to be there doing a good job because it's very unlikely that buyers and sellers will start showing up at the same time."

"It does get very expensive to connect to every exchange that our customers want," she continues. "It is important to embrace new initiatives but you have to keep up with them and understand the features that attract people to them and how to best serve your customers. Deciding to go into a new market is often a chicken and egg situation. You may want to support a product because you think it's a great idea or, more often, because your customers want to be there. But you need to make a call before it even launches and by talking and listening to people you should come to an informed decision."

Martin understands that increasing liquidity is good for the whole industry. "We're not afraid to spend time in helping exchanges like NLX or Eurex Asia to bring new liquidity," he says. "Our main concern is that there are many large liquid markets that we simply can't reach as a remote player. We spend a lot of time trying to persuade exchanges and regulators in far-flung jurisdictions to let us access their markets and that we are there for the long-term."

Aucamp says that OSTC is often an early adopter in participation with new exchanges and trying to help steer them. "Often we're not in a position to add much liquidity to brand new products at exchanges immediately like we can to more mature more liquid ones, but we certainly try," he explains. "We try to point out what features would assist us to get involved as this should be representative of the 'loca' demographic. We won't necessarily end up trading there but if we can move the meter a little bit it helps us and it helps them. In Asia the volumes do look fantastic but the contract sizes are small and the cost base to trade is so high in comparison to the contract size. That makes it very difficult to add meaningful liquidity for a business like ours, especially if you want to do it by trading complex, multi-leg strategies, which is how we work."

He believes there is a need for education with respect to the exchanges. "We talk to them regularly and describe how our business model works," he says. "We ask if products could be designed with a larger contract size or a lower cost base, for example as we are more concerned as 'locals' by cost than specific contract specifications. It's a long process but we're all here for the long run. If our traders have become proficient in the major, more liquid products and have bigger balances to trade with they can start experimenting in other areas, but many of the peripheral exchanges just don't have the product suite that works for our style of trading. As our traders find a new market or concept that they believe they can trade successfully, they have to prove that through testing. We'll connect if a commercially viable case is made and proven."

Grob is keen to emphasise how much effort his firm expends simply to keep the status quo, even before looking at new markets. "Keeping the wheels turning on 200-plus cash and derivatives venues around the world is a huge amount of effort and cost given the number of technology upgrades and regulatory demands," he says. "Then new venues come and tell us how they are going to be different and say that we must connect to them. We have to make some tough choices. Gone are the days when little ISVs would take a punt and build something. Everyone wants to be more assured about how they extract value from the upfront effort they put in. We try to figure out with our customers the consensus on a new venue before we decide to write to it."

MAKING IMPROVEMENTS

The panellists were also asked to put their finger on one thing that would significantly improve their business operations.

Martin puts the emphasis on connectivity. "The technology is mostly in place but the issue is not being able to get access because the regulators won't let you or the currency is closed," he explains. "We and our clients want access to liquidity pools so we can enhance them by giving other people access and help them grow. That is one of the reasons we are keen to support new exchanges because they let us play. Let us play and we'll be very happy."

According to Saade, market data is a major issue. "In the US there is the consolidated tape and it's a fairly straightforward process. In Europe, it's a nightmare. You need the market data but the associated fees are very high. The cost of getting meaningful data that is actually relevant to your business is absolutely crazy if you are a market maker or a broker. If you have to redistribute it it's even more expensive."

"Having a consolidated tape would be very helpful," she continues. "It has been mandated by ESMA, at least for securities, but it seems that it will be complicated and there is a lot of resistance from people with vested interests. It's very difficult to say that you are in a transparent and fair market if you don't have the data."

A major issue for Aucamp is that the distribution of profits made in the market in general is out of balance. "Certain participants earn a disproportionate amount of the revenues earned in our industry. Some participants really do get short-changed on how much revenue they can extract and in itself that stops innovation because there just isn't the revenue there to warrant taking the risk to innovate in the first place. Better distribution of profits as a whole would be a very positive long-term development for the industry."

Grob believes that the move of fixed income and foreign exchange markets towards electronic execution and more transparent regimes will be advantageous. "I'm happy that global regulatory momentum is headed this way because that is one of the things Fidessa is particularly good at. But markets like fixed income and foreign exchange have their own idiosyncrasies, and while it's inevitable that's where they will end up, no one has quite the right business model yet. It seems like every week a new fixed income trading platform is launched and all this does is fragment the scarce liquidity that is available. I'd like to move things forward five years and have the new market structure in place."

Grob does not believe that swap execution in Europe will just be about the central limit order book. "One reason some asset classes trade the way they do is because it reflects their underlying nature," he says. "The corporate bond marketplace works on general characteristics so, for example, people might want something that's AAA-rated with a particular tenor and coupon, but they will be relaxed over the exact instrument or sector it is in. Conversely, in equities or futures, you are much more specific about the thing you want to trade and so we won't ever get to the 'one size fits all' approach of central limit order books."

This period of no one quite knowing how the markets will work out means a lot of time is being wasted. It's not clear whether OTFs will emerge as the European equivalent of SEFs, and even less clear how they will interact with them. And yet the swaps market operates globally and so, if you could go straight to whatever the final outcome will be, you could then decide whether or not it's a sensible business to be in."

Grob believes that this is further complicated by all the vested interests that exist within the large banks. "The major global players are basically having to make a bet," he says. "Either they will be in market making or in the intermediation business, or facilitation via an agency model. Different firms are assessing this depending upon

"Some participants really do get short-changed on how much revenue they can extract and in itself that stops innovation."

Jonny Aucamp, OSTC

how quickly they think things will move. There is also a personal dimension to this that affects the careers of the individuals. Some might say, if I can keep the status quo going for two more years then I'm done and it will be someone else's problem."

Some observers believe that vendors, exchanges and clearing houses can act in ways that will hinder innovation and that it is sometimes too difficult to implement new ideas. Martin agrees that innovation is needed to grow and change businesses. "Perhaps we need to learn that we can't just automatically default to the ISVs and ask them to build things for us because they either won't or you'll have to wait for it when you actually want it now," he says.

"Getting angry with technology providers doesn't really work. If you need to innovate, innovate first and then build later. If you have to manage that for a while yourself, that's the way it has to be. If we can get something up and running quickly to service our clients, we'll get that built. Rather than go to an ISV and demand something quickly we now do it ourselves and build the full robust solution with correct specifications maybe three or six months afterwards."

Grob draws from his long experience in the technology provision industry to answer this charge. "When I ran a smaller IT firm we had the flexibility to change direction very rapidly and so it felt like we could do anything we, or our clients, wanted. This, however, was something of an illusion, especially when you looked at how robust and resilient the end product was.

"It's easy enough to mock up a screen that seems to do what you want, but actually making it work safely and resiliently is another matter altogether. Given the complexity and interconnectedness of markets today, the amount of testing required is way harder than it looks. This is because it's not just about checking the software does what it's supposed to, it's making sure it doesn't sometimes do the wrong thing or create any other unintended consequence. Often, in those old days, we would find that rather than go quickly, we'd actually tripped ourselves or our clients up. It's important to emphasise that building technology properly is hard and takes time."

"If something is only a good idea for six months, it's probably not worth building a system for it anyway," he continues. "I don't think that we as vendors are the critical path in stopping innovation. In fact at Fidessa we focus on doing all the technical heavy-lifting for our clients and then provide them with their own surface which they can plug their innovation directly into."

NEW OPPORTUNITIES

The panel also offered their views as to the greatest opportunities available in the new environment.

GHF sees huge opportunity in Asia, according to Martin. "It's not so much about intra-Asia business but about flows into and out of Asia, which are immense and continue to grow. China is a huge opportunity and its markets are opening up. A lot of management energy is spent on how we can encourage Asian exchanges to become more open and allow international participation from remote locations. Some of this will be for the long haul but we believe we'll be doing some interesting things even in Q1 2015."

Saade believes that MiFID II should also be full of opportunities because of the need to work differently. She also hoped that with greater transparency would come more trust. "At some stage we'll manage to link equity markets globally. Derivatives markets have been linked for a long time, but the equity markets remain very local. There is a push for this in Europe but people are still trying to get their act together after the crisis. They will gradually get to this and the sooner the better because globally there are so many opportunities and the equity markets are missing out."

Grob focuses on the buy- and sell-side customer base that Fidessa serves. "We have some 25,000 screens installed and one of the biggest untapped opportunities for us is what we can do with that community."

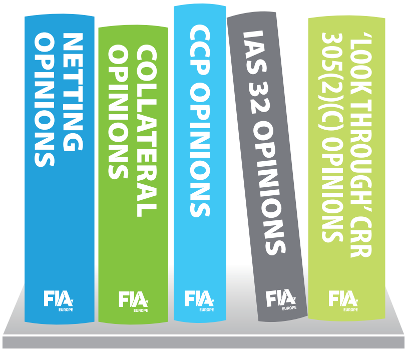
Aucamp sees the opportunity in the limitless pool of young people wanting to get involved in financial markets in every country he visited. "That might be in equities, FX or the futures industry: as a proprietary trader, as a broker, as an analyst, or as a hedge fund manager. We all have a responsibility to ensure that there is an arena for them to come into where they can sustain a career and make money. The last eight years hasn't dampened anyone's enthusiasm at a graduate level. The whole world is still a huge opportunity."

Ending the panel on a contentious note, Aucamp asks if advances in technology could make many of the issues that had been discussed, superfluous. "I don't think it's going to happen now, but perhaps in 10 years time, will the advent of block-chain technology have the potential to do away with the need for CCPs and centralised exchanges?"

Grob had no clear-cut answer but he too could see the possibility of alternative market mechanisms. "The job of equity markets is really quite simple," he said. "It is to get money out of people's pockets and into companies so they can grow and be entrepreneurial. That sounds simple but when you look at how complicated that process is and compare it with completely new business models like crowd sourcing projects you find that there are much easier ways of getting money out of people's pockets and into company's balance sheets.

"So, does our industry have to be as complicated as it is? Could there be, for example, more of an eBay style model that would enable traders to get more creative about how and what they trade. Technology will probably stay ahead of the marketplace, but it does get dragged back by market and regulatory complexity. I think it'll stay complicated for a while to come."

Is your firm subject to regulatory capital and international accounting requirements?



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- Netting opinions
- Collateral opinions
- CCP opinions
- IAS 32 opinions
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INTERVIEW: NIGEL FOSTER

INTERVIEWEE

NF **Nigel Foster**
Former Global Head of Derivatives at BlackRock and Head of all market facing activities, including trading, for EMEA region

INTERVIEWER

VW **Victoria Ward**
Founder, Sparknow LLP

There is a growing concern among the buy-side that all costs roll downhill, that actually the cost of doing everything is increasing, and the impact this will have on liquidity and so on. Nigel Foster has seen it all from the buy-side. As a really early user and adopter of derivatives, it is of great interest to get his insight into how the world is changing and how it has done so over time.

VW Nigel has had an extraordinary career. The thing that really strikes you if you go and look at his LinkedIn CV is he's spent 27 years and six months in the same place of work. It changed its name, he never changed his! During that time, and when he left, he was Head of Trading and Liquidity Strategies Group for the EMEA region, and oversaw all the firm's market-facing activities.

For the last eight years that he was at BlackRock, he was responsible for all global derivatives at the world's largest asset manager. And during his time in derivatives, he's done some exceptional things. One example, to give you a sense of the scale of the work that Nigel has done is in the collapse of AIG in 2008, he was the person who led the rescue, the restructure, $182 billion worth at stake. The taxpayer came out $30 billion ahead. Following your retirement, how are you spending your time, Nigel?

NF Well, I left BlackRock in June of last year, and I'm on a sort of gap year until the beginning of July this year. But after some holidays, rest and relaxation, my main focus is on my book, the whole story of derivatives with all the anecdotes, called 'The Derivatives Game', which is virtually complete and ready for publication.

VW I wonder if we could travel back in time over the years of your career, and land on the moments which feel to you as though they've got some similar qualities in the past to the kinds of challenges the industry is facing today, and what lessons might be taken from the past.

NF Back in 1981, I remember, the whole thing about the clearing model was to do with the fact that in America, you didn't have anything standing behind clearing apart from the members. And then this new thing called a European model came, where you actually had a taxpayer standing behind. In the UK you had the Bank of England, which forced the big five banks to stand behind the London Clearing House, as it was then, and then you had the French, who, in order to be competitive, actually formally put the Bank of France standing behind what was then their exchange, Matif.

The reason that is extremely important is because a lot of the costs we're seeing now, and a lot of the hassle of the structures, are to do with the fact that the only thing Europe wants, and the only thing that America won't do, is under no circumstances will the taxpayer stand there as a last gasp. That's why there's such a hassle, because there's such a battle going on between clients, banks and the clearing houses, on the capital front. And that will unravel because somebody's going to come out with a model, maybe not in Europe, where a central bank stands behind a clearing house, the capital requirements fall radically, and they will be winning the game, and everyone will have to move away from the non-taxpayer standing behind the CCP.

Big changes have happened. In the 1980s, you would go onto the floor at the Royal Exchange, full of people. You used to go into the brokering houses, full of people intermediating between clients. Then, all the trading floors collapsed. I don't mean literally, but basically there are no people left trading on the exchanges. Now you're seeing the final vestiges of a breed called the sales traders, who have disappeared because, certainly with the derivatives business of BlackRock, we watched ourselves from about four years ago to last year go from a very small percentage of electronic trading to as much as we could do.

With that shift to electronic trading, came issues to do with liquidity, particularly from the bank environment. The banks have withdrawn from being any kind of buffer or provider of liquidity. So that's a big change. There is no liquidity buffer, and curiously enough, it's now the buy-side, because everyone's moved back from this agency model. In the 1980s, it's hard to believe now, but firms didn't do proprietary trading. Then you had this giant successful beast called Salomon Brothers under guys like John Merryweather, who actually made a fortune out of it, and they spun off into hedge funds. But actually we're now back to the agency model. It's being forced by regulators.

The central thing to me is the clearing model is wrong, and it's being badly messed up. This business where you can steal clients' money to protect a clearing house by taking their variation margin was nearly killed stone dead a year ago. But actually that's all creeping back in now, and it's ridiculous because it goes against one of Europe's major criteria, which is they shouldn't enact anything that actually hastens a crisis. If you've got a clearing house that you think may or may not fail and if it does, they're going to steal the clients' variation margin – what are you going to do? The first sign of trouble, you're going to close out the whole position. So you're actually going to precipitate a crisis in a clearing house that you wouldn't precipitate if you knew there was somebody standing behind it.

Again, the banks are first of all much better at regulation and government stuff than the buy-side, because virtually no buy-side firm did it. Five years ago, at BlackRock we had no government relations department, and we had no one on market infrastructure. We now have about 24 people on government relations, and about 12 on market infrastructure. The reason for that is the regulators were coming to us, because we were the biggest asset manager, and a lot of the smaller buy-side firms were being crowded out, because they can't possibly sort of afford the cost base of having people doing that. So we ended up doing a lot of that.

VW Obviously the distribution of profit, and the distribution of cost, feels out of balance. What is the relationship between the buy-side and the sell-side now? And how is the cost equation going to be solved?

NF It's moved around a lot. At one time, a lot more was going to be borne by the buy-side, but essentially the cost of the new clearing regime is much higher. The banks, in their fees and all the rest of it, are bearing much more than their costs would justify. In the end, they're doing it to maintain their market position with clients, but ultimately, those costs that they're bearing can't actually be covered by the fees they're charging. If you look at areas like trade reporting, for example, investment managers have had to do a heck of a lot in terms of infrastructure build in order to meet the trade reporting requirements of their clients. The people who've been left without any costs at all are the clients themselves. They'll bear them eventually, but the clients haven't been asked to do much in the way of trade reporting, it's being done by the banks and by their investment managers.

The ultimate cost probably won't come through for two or three years, especially because, in Europe, anyway, a lot of the compulsory clearing fees aren't coming in until May, 2016. So I think the cost is high, but people often look at the infrastructure and the cost of servicing the client, so we're building this out. What's it costing us to provide the client? But the real overarching cost to investors is having to put up absolutely massive amounts of margin in order, particularly for the new OTC structures. And a lot of that comes back to the fact that, somehow, within this structure, for some sort of one in five million event, the market itself has to provide the capital, to recover the market.

The argument, which only occurred about two and a half years ago, on restitution or recovery of the clearing houses should have been a quick discussion, but is still is a long way from being resolved. The model's got to recognise that the 'too big to fail' is the clearing house, and that the taxpayer or something's got to stand behind it, because for really remote events, the amount of capital that banks, investors and clearing houses are being encouraged to put up is going up and up. But that's just not sustainable, in my opinion.

VW So it sounds like there are still some tough times ahead, but the title of this conference is 'the state of the industry, stuck in the mire or looking ahead to new opportunities'. In that landscape, that you've just

> "The amount of business being done in really complex instruments has collapsed. And that's a really good thing for the industry as a whole."
>
> **Nigel Foster**

described, where are the new opportunities? Where should we be looking for opportunities?

NF A lot of the people here are in the software industry, in the exchange trade environment, and OTC, which used to sit outside exchanges, but is now obviously coming in. Already, for example, virtually every OTC swap trade that BlackRock does, and most of CDS in the United States, is cleared now. And there's a golden opportunity in this. One of the legacies of things like AIG Financial Products, and that mess that came up in 2008 and early 2009, is finally people accept what they maybe should have accepted as long ago as 1998, when LTCM, the large hedge fund went down. They've finally come around to accept that actually people are creating products that are far more complicated than they, themselves, understand. So obviously they're very high-margin products for investment banks, but the amount of business being done in really complex instruments has collapsed. And that's a really good thing for the industry as a whole. It's much more vanilla.

VW Do you think it's likely to stay that way?

NF Yes, I do. The only area that's got more into complexity is market infrastructure, because one of the things you find is that around this room, we've got loads of subject matter experts. If I actually interviewed each of you in turn, and asked you to explain the whole picture of what's been tried and they're trying to achieve in the new market infrastructure, how it works, and why it's like that, I may be wrong, but I bet you most people would only know their little bit.

We've had discussions with regulators, and they've got all these things – the trade reporting, and the formats they want them in, and who you send it to etc. And we've had a pretty open dialogue because they weren't too keen to talk to the banks and we actually said, you go show us who's picked the information that's being sent through and how are you going to look at it?

There's an awful lot of the information that we think we need, so we can say that we know what's going on. But actually for the first nine months we weren't allowed anyone at the receiving end of this information. My favourite anecdote is going to the Financial Stability Board (FSB) to talk about market liquidity. And, as you know, the FSB was brought in after the financial crisis, to look at where things could really go belly up in the industry as a whole, and to step in and point it out and say, 'whoa' on things like CDS. Anyway, towards the end of this discussion, we'd pointed out some real concerns around liquidity in corporate bonds and some of the issues around credit. And they listened, and then a rather outspoken guy said to the chairman, 'if I was to convince you there was going to be a liquidity crisis in corporate bonds, and people were basically investing far too much in far too many liquid things, and interest rates go up or whatever, this thing could be a real thing. What would you do? You might form an opinion it's 30%, 40%, but let's say it's 99%, what can you do?' And the chairman said, well, probably nothing, because we could warn people, but it would be their choice whether they bought into these things or not. To which the guy said, 'well, to be honest, you've just told me that the FSB can't do the job it was set up to do.'

The reason I tell you that anecdote is I think the regulators are being very demanding. They're asking for a ton of information they're never going to use. Over three years' time, when everything beds down, people will have had to build a whole new infrastructure to provide stuff that they'll tell you we don't actually need anymore, because if you've got two-way reporting on trades, you know everyone's positions, and who's got them etc .

So let's say it's like something like CDS, which is a particularly popular one. Who is going to say, 'wow, the build-up in that particular area or those particular institutions is dangerously high, stop it'? It's basically electronic paperwork to cover bottoms, it's not really serving any purpose. But at this juncture, it's an irresistible force, and everybody has to come up with stuff to do it. And of course, for people doing software and systems, it's money in the bank.

VW Well, that sounds like a slightly optimistic note to end on. Thank you Nigel and we look forward to seeing your book in 2015.

SESSION TWO

WHO BEARS THE COST OF COMPLIANCE?

From left to right:
Steve French, Phil Simons, Hannah Meakin, Mark Green, Andrew Douglas, Nick Chaudhry, David Brown, Clive Furness

MODERATOR

Clive Furness
Managing Director, Contango

SPEAKERS

David Brown
Technical Manager, Derivatives Operations, Royal London Asset Management

Nick Chaudhry
Director, Head of OTC Client Clearing, Commerzbank AG

Andrew Douglas
Managing Director, DTCC

Mark Green
Global Head - Product Planning, Post Trade DerivativeSolutions, Sungard

Hannah Meakin
Partner, Norton Rose Fulbright

Phil Simons
Head of Sales & Relationship Management, Eurex Clearing

Steve French
Director of Product Strategy, Traiana

From here on out we, as an industry, are going to be “treading our way gingerly through the minefield of cost”, Clive Furness declared as he began the second panel session. The cost of compliance is a large part of that and seems to be the driving force behind most of the changes we have seen within the marketplace. The rather ‘voluminous’ panel who joined Furness spent the next hour discussing which industry players will have to endure the cost of compliance, how they will go about doing so in order to keep costs down, and the subsequent outcomes.

Speaking from the point of view of an asset manager, **David Brown**, Royal London Asset Management, commented that not only would IT infrastructure pose a large cost, but also, “the extra margining it will take to clear trades, the increased resources required across fund managers to provide oversight for the compliance and also the substantial costs of implementing all of this” would have a big impact for the buy-side. What seems to be happening with reporting, for instance, is that some fund managers “have built in-house solutions which have been quite expensive on the infrastructure, whereas others (probably those who came along a bit late to the party) have delegated a lot of that reporting.” **Nick Chaudhry**, Commerzbank, observed that delegated reporting is bringing to the surface the realisation that actually, “the true costs are starting to fall out and are being passed down.” The idea that trade reporting can be free, is no longer considered a reality, rather a myth, that is quickly forgotten at the bottom of the value chain. Chaudhry explained: “There is no value in pretending that this infrastructure and these regulations can be carried out for free. If you’re providing solutions for clients, whether you’re a software company, a middleware vendor or a clearing broker, there are real costs, and they are starting to leak into the marketplace.”

The focus quickly shifted on to what can be done to alleviate these costs. **Andrew Douglas** from DTCC, an infrastructural solutions provider, says that it is becoming apparent that a business must consider how it “can afford to build the solutions in order to stay compliant, as well as, the clients who are using the solutions”. For example,they may no longer “be able to provide services across broad panoply of asset classes”. By consolidating business, it is possible to become more efficient in terms of cost.

Douglas explained that DTCC "covers a great percentage of the globe, but simply cannot afford to be everywhere, so there are some markets where DTCC has made a decision not to provide a service." And that obviously has a flow-through impact on the clients who then don't have access to a global solution.

SunGard's **Mark Green** agreed that businesses are being obligated to consolidate their workload. "As a technology and solutions provider," he said, "there are three main components to our costs and the costs to our customers. You have the ongoing support of what we already supply, the regulatory responsibilities, and then there is the new stuff, new solutions that create growth." With Dodd-Frank and EMIR, organisations are busy tying up the regulation side of things. In addition to the regulatory aspect and ongoing maintenance, SunGard is focused on developing new and innovative solutions and services to help support customers in lowering total cost of ownership and maximising their operational efficiencies.

Hannah Meakin also recognised that the main focus is on the "complexity and new requirements" that have appeared with EMIR and MiFID II. She touched on Douglas's point that businesses working on a global basis are shying away from certain markets because, "some of these regulations are really not sufficiently tailored to different parts of the market that they're affecting. In a lot of cases, one size fits all. For example, if you take a pension fund that trades one derivative a year, EMIR will affect it in exactly the same way it would the banks. They still face the same issues around interpretation."

Steve French added that when a new regulation surfaces, the first thing you need to do is research the impact on your company and the existing infrastructure, as well as the impact on the customer base. He agreed unequivocally with Meakin that, "the comprehension cost is monumental." Then there are all the additional costs that come along after. One of which, **Phil Simons** observed is, "capital costs that are there to reflect the risk that you are taking in the market; the more risk you take; the more capital you need to put aside to cover that," so a lot of the costs come from covering risk. This is also strained further by "the complexity of the leverage ratio". Returning to Furness's initial question of who bears these costs and what can be done to bring them down, Simons offered up netting as a solution. "Everybody is trying to work with technology companies and the clearing houses to develop compression and more sophisticated netting services."

BROKEN DATA MODEL

This prompted the conversation to shift to a further hurdle that is driving up costs; the issue of a 'broken data model'. French explained that there are different vendors and systems and there are different ways of doing things under different jurisdictions. The idea of 'big data' – keeping it all in one place, "is something that's been talked about for years, but I think 2015 is going to see the start of actually trying to crack that nut," he said. "I think the first six months of this year will be when people see what can be done as we move towards new clearing mandates," he added.

Green concurred that there is "definitely a desire for consolidation, especially because of trade reporting. There is debate around how it should be reported and in what form and what content is needed. Every time there is an evolution of that, you have to look to all these disparate systems to collect that data." So there is a push for 'big data' but it seems far easier to say than it is to realise.

Brown took the stance that some fund management firms are ahead of the game, stating that they got on board early and invested heavily in trade capture and data management infrastructure, which enables them to design in-house reporting programmes in line with the regulations. "Those who have taken a back seat have a fair amount of catching up to do and will have to rely on vendors to supply data management services."

In investment banking, Chaudhry pointed out, it's a very different story where "a lack of a harmonised approach has always been there," and interestingly, he doesn't blame it on regulations. Instead, he believes that the best practices coming out of EMIR "do actually have consistent single capture platforms to deal with all derivatives across the whole spectrum of the bank, the hedge fund, the asset management or the pension plan," even if they are slightly "one size fits all". Chaudhry also mentioned that although the regulations are designed so that no one makes money off them, "the buy-side has to employ the services of vendors in order to be compliant with some of the

> "There is quite a lot of information that's available at no cost… it is playing a small part in helping the industry get to grips with regulations."
>
> **Hannah Meakin, Norton Rose Fulbright**

regulations, because the costs of doing it directly are just too much." This helped to illustrate his opinion that "there are conflicts everywhere, but maybe there's a balance to be found where we reduce the cost of supporting this new infrastructure and allow buy- and sell-sides to operate efficiently but also remove some of this systemic risk from the system – but it's going to take some time to get there."

The role of the CCP then came into question, with Furness suggesting that there is "more opportunity for CCPs and exchanges to offer significantly more services, that have traditionally been sell-side, such as collateral management and collateral optimisation." Simons was hesitant to agree as he remarked, "there are certain complex structured products that should not come anywhere close to a CCP. Instead, we should be clearing standardised, commoditised type products; that is where a CCP can add value." He also explained there are some 'natural' areas where CCPs can offer additional benefits to the market, such as cross margining. Ultimately, the more you can integrate funding and standardise messaging, the more costs can be reduced. Simons also made clear that "the CCP has to be very specific about its role in risk management and defining the role and sticking to that is fundamental."

Furness steered the discussion to the idea of collaboration. He asked, "do you see the role of the clearing house, to work with technology companies to introduce new services more efficiently and therefore lower costs?" Simons responded that it is necessary for all the vendors to roll-out a new product, or service to their members at the same time. "Nobody can really launch anything in isolation; you've got to have an exchange launching products in conjunction with the clearing house, and all in conjunction with the vendors," he said. While Chaudhry supported this view, Douglas, rather than choosing to speculate, observed that "the environment is constantly changing, making people rethink their business model." Regulations will continue to "force people to think differently about the industry they operate in", and the various infrastructures, or providers of service will have their "time in the sun", he added.

Furness then looked to Meakin to explore the "fundamental changes clients, from various sectors of the marketplace, are making to the way they look at markets on a legal basis". She responded that there have been a few trends, one of which is "more collaboration between different firms within the same parts of the industry," stating that when trying to influence how legislation is developed, it is more efficient and more easy for the regulators to react to a united voice.

Some of the industry associations' developments, she went on to say, "such as working together on industry standard documentation, protocols and legal opinions are challenging the way legal advice is traditionally given, especially if you consider traditional charging structures and conflicts of interest, so lawyers are adapting and beginning to change their approach." Also, in terms of value added service, Meakin explained that, "there is quite a lot of information that's available at no cost, not just from lawyers, but from accounting firms and compliance consultants, and although it's often quite generic, it is playing a small part in helping the industry get to grips with regulations."

OPERATING GLOBALLY

Returning to the issue of operating globally, Furness argued that there is still much more that can be done on the legal side due to the complexity of the different structures that are in place in different jurisdictions.

"The fact is that rules, laws and regulations for all the different types of entity in every country are vastly different, and in many cases, incompatible," He said. This prompted Meakin to add that trying to resolve these issues and move towards standardisation, will prove very complicated and "even more expensive, purely because of the complexity that's been introduced to the system".

Brown expressed that "one of the bigger frustrations has been the cost of negotiating legal documentation. When we approach brokers for a standardised contract they often instead produce their own customised contract containing terms that we have not previously experienced. Therefore, we often have to call upon the services of an external counsel, which can be very expensive. The buy-side are not benefiting from standardised contracts, because the 'big players' aren't using them without considerable customisation and it seems as though the buy-side is picking up a lot of the cost. Of course, achieving standardisation in this area will not be easy in an evolving market and there also needs to be a mechanism to enforce all of the counterparts to use the standardised documentation. Otherwise we'll still end up in the same situation of having to negotiate numerous bilateral contracts."

FIA Europe's Simon Puleston Jones argued that "over the medium term, standardisation is helpful for everyone, because we're all in this business where we need to hire people, and it's much easier to hire someone who already understands what the industry standard document is." He wasn't worried about enforcing it, because although it's not something that will happen anytime soon, there is a wide interest for it across the board and could be a case of simply leading by example.

Furness then asked the panel to look into the trading chain and investigate where some of the costs stop, and who is going to bear those costs. Starting with the sell-side, Chaudhry observed that for Commerzbank, it's about focusing on the associated costs of management. "It's about being able to package things up, things that you run on very tight margins, as long as you can provide services on a holistic basis to clients." He added that "fundamentally the costs will roll down the line, but hopefully it dilutes as it goes."

"Fundamentally the costs will roll down the line, but hopefully it dilutes as it goes."

Nick Chaudhry, Commerzbank AG

Simons interjected that although the listed business for banks and CCPs has been a profitable business for years, the pricing models around that will probably change. For example he added: "In the OTC derivatives world, we as a clearing house have invested a small fortune in having to build systems and continue to invest in them as the regulators bring on more and more." Simons then asked, "How long can investing ahead of receiving any revenue go on for? Can other businesses cross-subsidise them and if so, does that then eat into their profitability? Or do they just take the loss on the chin, hoping that in the future it's going to be more profitable, or do they pass it on to the asset managers?"

Increased costs will inevitably lead to consolidation, as Douglas pointed out, "because certain players won't be able to afford the costs being passed down to them and because the sell-side isn't prepared to pick up that cost." There will be fewer banks and asset managers, but they are going to get bigger, "the market won't get any smaller, it will just be fewer players," he said.

The only other option would be to invent new models but Simons suggested that even the regulators won't want that, however "they do need to consider a real option that will work in a way that isn't detrimental to the market, and then make some tweaks with regard to how you capitalise this stuff." Until that happens, the irony here, Douglas pointed out, "is that the legislation that's been passed to

“It’s the medium-sized firms that face the biggest challenge of financial constraints to cope with all the changes.”

Mark Green, SunGard

address the issue of too big to fail, might actually create more [too big to fail].”

Returning to Green and French, Furness asked, what are the primary clients of software platforms demanding? Green said that “our customers talk to us about their overall cost structure and the changes in it being driven by what everyone is calling ‘the new normal.’ We help our customers by looking at ways to reduce their total cost of ownership through our domain expertise and by our ability to deliver more efficient processing. The software infrastructure is already a high cost to the sell-side, so it is vital for firms like ours to develop new technologies that will keep costs down where possible in terms of upkeep of the systems, while increasing time to market for our customers.” For SunGard, “it is very much about working with our customers to innovate, automate and standardise as much as possible of their middle and back office functions. These are the areas that are not competitive by nature,” Green explained.

French stated that it is also beneficial for software providers to be flexible. The one size fits all solution doesn’t always work. Innovation is also high on the list of priorities, as well as taking a collaborative approach. He explained that “Traiana worked closely with trade associations and other industry players to come up with a solution to the limit checking requirements that is now in production and working.” French says that maintaining consistency is key in keeping costs down. The connectivity to the street may change, but if you have to keep “changing the plumbing,” costs are going to increase. With regard to the idea of outsourcing to save on costs, Warren Buffet’s mantra, “if it increases in value, buy it. If it doesn’t, lease it,” was uttered.

To bring the lively debate to a close, Furness posed one final quick fire question to the panel: “When it comes to the cost of compliance, who are the winners and who are the losers?” Brown responded decidedly that, “the winners are the legal profession and CCPs. The losers are the smaller firms, who don’t have the economy of scale to implement all of the changes.”

Chaudhry was more diplomatic, commenting, “It’s a changing marketplace, and ultimately the regulations are put in place to provide a more stable environment, and that’s a positive.” Douglas however, was in agreement with Brown stating, “the small guys will suffer from this, and for the moment at least, CCPs seem the place to be.”

Green offered a slightly different view. “The sell-side is clearly being hit a lot in terms of cost,” he said, “the large sell-side will have the financial backing to push through it and the small sell-side might be small and agile enough to be able to depend on and delegate to larger firms to get through it. It’s the medium-sized firms that face the biggest challenge of financial constraints to cope with all the changes.”

A different perspective was given by Meakin, who asked us to think about the regulators. She said, “it’s not a question of making money out of regulations, but they are clearly becoming more important.”

Simons wrapped up the discussion, saying, “in one respect, everyone is a winner because the world is going to be a safer place. On the other hand, everyone is a loser because of the fortune that will have to be paid for that safety. The relative winners are going to be those that can change and adapt the quickest in this new world, and the losers are those who continue to bury their head in the sand and hope it’s all going to go away, because it won’t.” French agreed, adding “the winners are those who innovate and are agile, across the board; vendors, banks, buy-side, FCMs and CCPs.

SESSION THREE

THE STATE OF THE INDUSTRY

MODERATOR

Bill Templer
Faventus Consulting

SPEAKERS

Stuart Deel-Smith
Head of Product Development, Nasdaq NLX

Stuart Heath
Executive Director, Head of UK
Representative Office, Eurex

Steve Sparke
COO, Marex Spectron

The industry is facing some challenging times and the final session, on 'the state of the industry', highlighted some of the areas of concern, but also looked ahead at areas of opportunity for FCMs and exchanges alike.

After some scene-setting from the panel chair **Bill Templer**, Faventus Consulting, the conversation kicked off with an analysis of the reason for the continuing trend of consolidation in the FCM space. As Templer suggested, the FCM business is "seeing a real struggle in terms of how to make money". In spite of the consolidation reflected in monthly CFTC data, "there's probably a very small number who are making any kind of significant profits at the moment."

There are host of reasons for that. "I think volumes have been a bit challenged, and interest rates being zero compared with where they were a few years ago, has made a very significant difference to the revenue stream of all the FCMs." And, of course, regulation has increasingly become a real challenge in terms of some of the capital costs and charges that are being incurred by FCMs.

These issues are all placing pressure on the clearing model, it was acknowledged, at a time when regulators need the service to be offered in order to meet their objectives. Yet it is regulation itself that is causing the biggest challenges to the model. Banks have struggled to identify the best approach to meeting new regulatory requirements – wanting to prepare for change, but at the same time uncertain about the new requirements and their impact.

Other factors have also come into play, including implementation of the Basel III capital requirements and specifically the leverage ratio (the capital measure divided by the exposure measure) placed on firms. These capital requirements are significantly burdensome, not just to the clearing firms but also to their clients, who ultimately face the pass on costs.

Such developments have led firms to have "re-pricing conversations" with their clients, specifically around those capital requirements. Part of that process was the need to address the costs of servicing different types of clients. Those with long-dated, directional portfolios, such as pension funds, for example, have become particularly expensive to service under the capital calculations.

Mandatory clearing of some OTC derivatives is also presenting operational problems as firms seek to bring their listed and OTC derivatives into the same environment. Both have different challenges, use different technology and different processes. There has not been a clear and outright winner from a platform perspective that can address the differences across these markets. There are additional differences in the approach to collateralisation between the two types of derivatives; segregation models in Europe and the US;

and a further complication being the difference between the agency model in the US and the principal model in Europe. Bringing all these factors together highlights the complications with the convergence of the two market segments.

From the perspective of a smaller FCM, Steve Sparke, COO of Marex Spectron was concerned by the prospect of further consolidation of the FCM space as a result of these challenges. "I think it will consolidate further," he cautioned, adding: "I think there are two levels of that consolidation. There are the visible withdrawals of certain banks, certain clearers, from maybe a whole segment of a market or even from clearing more broadly. But I think within each bank, depending upon its state of understanding of its capital and liquidity requirements and the impact of its listed business on all of that, you're seeing either re-pricing, or you're seeing a number of areas quietly exited without necessarily a press release. So I think you're seeing quiet withdrawals, and I think you're also seeing consolidation in terms of the clients that they're prepared to cover."

While major investment banks might have a long client list, at the bottom of the list may be clients that the bank does not really want to offer a full clearing service to. In those cases they will either start to squeeze them on the price or move them out. "I think I heard somebody refer to a bank on-boarding section recently as becoming the bank off-boarding section in some cases. I'm not sure it's quite that dramatic."

This withdrawal of services to some clients led to the question of where those clients will go next. "I probably represent the biggest of the small clearers, in terms of the capitalisation of the organisation I help run," Sparke explained. "We're probably at the lower end of the clearing members, and below us, there are people who are basically indirect clearing with the banks."

The smaller clearers are being squeezed out of this, he continued. "The capital requirements, the increasing default funds, the cost of being a clearing member of any clearing house, rather than any exchange, are steadily increasing." Furthermore, it is not necessarily capital alone that is an issue, it is "pure liquidity".

"There is a limit to how much cash you've got in the bank. So if you're handling even major execution flows, and you're taking asset allocation trades that run across a day, and they're in big equity indices or frankly in the LME product where we specialise, the margins, say, of VWAD [volume weighted trade across a day], the exchanges move and the clearing houses move to intra-day margin calls means that almost on a real-time basis, even the smaller brokers are going to have to find very substantial liquidity resources."

"Within each bank... you're seeing either re-pricing, or you're seeing a number of areas quietly exited."

Steve Sparke, Marex Spectron

Templer suggested that the industry could respond to the concerns over cost and liquidity by charging more and changing processes so that clearing firms receive the cash 'up front'.

Sparke responded that the industry is reacting in both those areas, but is still at the start of the process. But there is still a lack of understanding on the part of customers about the need to re-price. "One of the things everyone has done is they've built unending capacity. So, until the shareholder effectively, of any of these organisations, turns around and says, 'my return is simply not enough', and actually starts forcing those business units to dramatically re-price, it's not going to happen."

There is further consolidation to take place, Sparke added and "people only start moving their prices up once people go out of business. So I think it's only when you see somebody walking away and withdrawing, that the penny has dropped.

"I still see plenty of people going out there, pricing at rock-bottom prices. I see people offering margin finance at some very strange rates that make absolutely no economic sense to me, when I analyse it. So I think we have a serious issue, serious challenges. I think people are starting to do it, but there's a hell of a way to go."

Ultimately, though, while this re-pricing process will be good for the industry, an unintended consequence will be that "you're probably going to end up with six clearers, bank clearers, as major members of all of the clearing houses. I think that gives you horrible levels of concentration. So the unintended consequence is it drives the margins up. It makes the end users pay. But because there's no money in it for any of the middle men, you end up with a massive concentration risk."

INDIRECT CLEARING

With the prospect of a continuing drop in the number of FCMs offering clearing, what is the likelihood, then, of a growth in indirect clearing? Eurex's Stuart Heath was concerned about the possibility of MiFID II forcing indirect clearing onto FCMs. "Indirect clearing is a difficult topic," he said, "largely because we don't have a huge say over the end client." The lack of control presents concern and "putting a clearing member under fire for not offering direct clearing is madness".

Sparke offered an alternative view that mandatory clearing may lead instead to an increase in direct clearing memberships. "You might see a lot of the people who can undertake all of the infrastructure work themselves actually just becoming a clearing member directly. And I think certainly some of the larger regional banks will be thinking about doing that."

Another option would be the potential rise in infrastructure providers allowing for what Sparke described as "clearing light", or an "interim participation model" where a firm may become a direct participant for a short time in order to facilitate the movement of positions in the case of a clearing member default.

It is not just the FCMs who are facing changing times, exchanges and CCPs are also going through a period of reassessment. As Heath explained, while the group is traditionally a 'vertical' model, "based on the regulation, I think we're more of a 'vertizontal' at the moment, because the clearing house is under so much scrutiny. And it's certainly not from the exchange side that costs are going up, because we haven't put our fees up."

Eurex is aware of and understands what is happening within FCMs, and the bank FCM model particularly, Heath stated. "We've put a lot of expensive infrastructure and legal work into trying to reduce cost. So we're in a similar situation. What we have become far more aware of is the cost for the end customers. We get a lot more direct contact with the end customers who are asking us what we're doing to help their clearing members try and reduce the capital cost to them, because now obviously the capital cost is charged through. Maybe it wasn't before. And also in terms of the leverage ratio and how that's going to affect traded volumes going forward on the listing side. A simple comment to me was the ratio may end up being the same on a one-year Euribor contract and ten Bund contracts. So where am I going to put my money if I'm a global macro or relative value fund? I think there are certain issues there."

The concerns over concentration are equally present in the CCP space, particularly in relation to the 'too big to fail' debate. "The ultimate test for us, in terms of risk management of CCPs, is a failure of two of our largest clearing members," Heath explained. "So, if our two largest clearing members become a lot larger, then the size of the failure is bigger and the margins we have to hold against all the positions and the default fund in particular, becomes larger, and therefore the capital cost to the clearing members becomes larger. So it's a self-perpetuating circle in many ways."

On top of that, he continued, the concentration risk goes further because of those capital charges are being passed on. "They're being passed on to the fund managers and the only way that a fund manager can cope is that they have to get bigger and get economies of scale as well, and have more things that they can maybe offset or internalise going forward. So there will be less visibility in trading, and less choice in terms of buy-side as well."

In an ideal world, said Heath, the industry would revert to a situation where there were still 180 FCMs all competing with each other in reducing costs, rather than all waiting for who is going to put the cost up first. "We talk to the clearing sides of some of the larger banks, and they're at the point where their management is saying, 'this is part of the bad bank. If you can only return 6% on capital, then do we want you as part of this business?'

And that becomes a worry," said Heath. "And I think things have to change".

Exchanges and CCPs should make things as simple as possible and ease access to the CCP. "If the clearing model has to be individually segregated, then we have to make that as low-intensity as possible," he continued, "to make sure it can be accessed by the clients; that they can get the capital savings and offsets required, and that the FCMs can service them cheaply. The big issue with a fund manager with 1,000 funds, each having to have an individually segregated account is more the sheer cost of administration and the segregation and the collateral movements than anything else."

Another factor for exchanges has been a decrease in volume and a shift in where that volume comes from. Bank proprietary volume has decreased so that even if some other sources of activity have gone up, the structure of the market has changed. Heath questioned whether this was good in the long term for the other major cost in the industry – liquidity.

Working for an execution venue rather than a CCP, Stuart Deel-Smith had a slightly different angle. He also looked back to a time where there were more counterparties in the financial markets. "Close Brothers, Rea Bros, Barings Brothers, Smith Newcourt, all these other names," he listed. "So you had a marketplace that more closely represented a competitive marketplace."

As a result of the consolidation of the last couple of decades, the market has ended up with a "quasi-oligopoly". While, there are fewer counterparties and credit lines have been squeezed today, there were inherent flaws in the structure of the market back then. Deel Smith cited the examples of LTCM in 1998, trading total return swaps with banks on zero margin, and other 'accidents' such as Amaranth in 2006, as warning bells that were not addressed at the time. It took the crisis of 2008 for regulators to wake up and recognise that there were structural problems that needed addressing.

However, "As is always the case, when you bring in regulators and politicians, the pendulum swings too far. And in this case they've really swung a baseball bat," said Deel-Smith. The concern is that regulators may not be achieving what they set out to achieve. By introducing mandatory clearing to allay concerns about banks being too big to fail, regulators have now shifted the concern to CCPs which are now in danger of being too big to fail. "Are we now concentrating all the risk from where we had in the early 1990s 100, 200 counterparties down to four CCPs?" Deel-Smith asked.

Templer questioned whether there were benefits and opportunities to be had from bringing OTC and listed clearing businesses closer together for banks. Integrating platforms itself is an issue, as he pointed out. The markets are different so the systems that service those markets are also different. "So when you try and align platforms, and I know that a lot of firms have tried to squeeze one into the other, whichever way round, it doesn't actually work. They are just different."

While the panel thought that such a step still presented challenges – clients who typically trade OTC are not necessarily the same set of clients that typically trade listed and are used to different account structures and processes – the view was that there were clearly some advantages to be had. Risk management departments gain a single view of risk, for example – which is beneficial for both the bank and the client – and client coverage teams also get an enhanced overview of activity.

SPECIALIST FIRMS

Sparke illustrated the lack of integration that exists, even within firms like Marex Spectron. "My firm specialises in commodity market execution, very big business in European soft commodities, in LME, metals, all things energy. We used to be a pure listed broker and about three years ago, we bought a company called Spectron, which was basically a European energy IDB. We've got execution on the listed side, execution on the OTC side. One is an agency model, the other is an execution only model. We've got two really successful businesses, but they don't talk to each other at all. They sit next to each other. We've got desks doing fuel oil sitting next to desks that are OTC, sitting next to desks doing listed gas, oil and ICE products and so on. And there seems to be almost no overlap. They use different languages. They use different methods of communication. The entire energy market seems to operate on Yahoo IM and various IM platforms."

While this appears to be inefficient, both business operate well and are good at what they do. "The message is, if you specialise and play to your strengths, you'll get paid," said Sparke. "We've seen a substantial drop off of all

“When you bring in regulators and politicians, the pendulum swings too far. And in this case they’ve really swung a baseball bat.”

Stuart Deel-Smith, Nasdaq NLX

the bank prop customers, because they were all playing the commodity markets as well as every other market. Our commissions, year on year, have actually just quietly gone up, despite all of that. The cost base, of course, has gone up, because of regulation and the associated costs.”

The industry is clearly at a watershed moment similar to the start of commodities futures in Chicago in the mid-19th century, or the introduction of financial futures 40 years ago. “It’s literally a paradigm shift,” said Deel-Smith.

PRODUCT DEVELOPMENT

While the catalyst for this change is regulation, clients are looking at how they can move their OTC activity towards the listed model. “So there is certainly a groundswell towards CCP cross-margining and efficiencies,” said Deel-Smith. “What I see changing in the exchange space is rather than listing one benchmark future, such as the US 10-year treasury, and concentrate the liquidity there, we’re going to end up with a broader product suite on exchange, with perhaps less liquidity on every single listed future.”

The whole market model will be changing to try and better accommodate the OTC flow coming onto a standardised listed platform to access the CCPs and portfolio margining. Deel-Smith saw new players coming into the swap futures space. “So it’s not just futurisation of existing swaps, but your hedge funds, your traders, your high-frequency traders, electronic traders would love to trade the swap rate, rather than the sovereign bonds. I actually see the swap market growing.”

Furthermore, there will always be OTC. “People need bespoke OTC swaps for cash flow purposes and hedge accounting and what have you,” Deel-Smith continued. “But I see that pool growing rather than just a bit of it being futurised. I think there are tremendous opportunities in this space going forward.”

Eurex’s Heath also saw positives ahead, although he differed slightly in his assessment of product development. “I think what we are seeing is a lot of differing opinions about what products will win and what products are going to be used. You hear, for example, one of the largest fund managers in the UK now says it’s no longer going to do OTC IRS. So they’re either happy to increase their risk, or they’re going to eventually look for an alternative to do it. That alternative could be swap futures. That alternative could be different sorts of bond futures. It could be repo futures. So I think there’s product opportunity.”

OPERATIONAL EFFICIENCIES

Technology also presents a big opportunity, Eurex’s Heath suggested, not just in execution, but all the way through the value chain. “For example, smart collateral management – we heard about 18 months ago that the big issue was that there wasn’t enough collateral in the world. That seems to have died, because they found the collateral, and now they’re working out how to move it. And actually, in the end, what they’ll find out is that they should just leave it where it is and pledge it and cross and do all this, books and records, and it won’t be an issue. So I think that just requires a smart system, and a smart allocation.”

Portfolio margining could also be a driver of innovation. “From feedback we’re getting, there are lots of people interested in it,” said Heath. “But they’re more interested in seeing what the real results are rather than our best case hypothetical.”

The benefits to all clients are yet to be seen, though. “If you’re a long-only asset manager, there’s going to be no benefit. In fact, if you’re too long, you’re going to lose out in some sort of liquidity add on. Maybe it's going to work for a fairly large hedge fund, for example, where they can put all of their positions that are fairly evenly matched up, in terms of risk, into one CCP."

Eurex is seeing demand, and from the clients who have moved, they have seen benefits in it. "But not all of them will see that, and they're the ones that probably haven't moved yet." While cross margining was not viewed by all as uniformly beneficial, Nasdaq has seen customers experience tangible benefits of cross-margining and portfolio margining.

"Here in Europe, you can trade across three different CCPs," Deel-Smith pointed out. "With the competition in execution, you could very well end up long Eurex, short on LCH. And I think there's an opportunity to do position switching." Optimising where your net resulting position is, which could be a pre-cursor to pressure towards inter-operability of CCPs, would be an advantage."

AREAS OF GROWTH

Recent developments in commodities markets led to a question about the challenges of that particular asset class. Sparke said one of the issues is the physical nature of commodities. "You've got a genuine supply and demand curve," he said. "You can't go out and print copper. You've actually got to invest in a plant, dig it out of the ground and produce it."

There is substantial volatility and activity in those markets, he said. "When anything is moving around like this, that's a massive opportunity for people to either trade it, make money at it, broker it."

Yet bank FCMs clearing commodities are under significant pressure or reviewing that business, the panel acknowledged. The main concern, as elsewhere, is capital. "The problem is, there is a finite turnover that you can expect from most commodity products," Sparke continued. "Possibly not in the energy space, which is interesting. But we see enormous innovation as new sources of energy come on, and people start trading emissions and they start trading greens and they're trading all sorts of interesting products.

In that scenario, as these products require clearing, it is the niche clearers who will pick up the smaller product business, he predicted.

As a ring clearing member of the London Metal Exchange, Sparke saw the potential in that market too. While the exchange has increased its fees substantially in the past year Sparke said it was effectively " testing the model, testing the price elasticity". So far, there has not been a drop off of volume as a result. "I think they're sort of living proof at the moment that you can push your prices up."

LME does face challenges at its looks to 'futurise', he added. "There is always a danger of throwing out the baby with the bathwater, and turning what is a very successful forward market into something that just looks like every other big exchange. But I think there's real profitability out there. And I think it's a very interesting pricing model and a pricing experiment going on in the marketplace."

Equally, Asia is still seen as presenting opportunities. For Eurex, this is probably the exchange's biggest growth area. Heath said it was looking to set up a clearing house in Asia to clearing the overnight business it does in Asia and move it back to Europe afterwards.

"The whole thing about extending trading hours, if you're talking about risk, is you could end up trading for seven or eight hours before the clearing house opens in Europe. So it's a simple way of putting in extended trading hours through your clearing house." Additionally, there are local rules that mean it is advantageous to keep collateral locally. "At the end of the day then if you do build a clearing house in Asia, and we do have Asian clients, they may well prefer to go the other way round and keep their European positions local to them as well. So I think there's a lot of logic."

Templer rounded off the discussion by asking the panel to outline their one business wish for 2015. Heath stated: "I would like the regulators to finish doing what they're doing so everyone can get back to business and start working out how to accommodate it."

Deel-Smith was a little more expansive. "I'd like Norman Lamont to come back," he joked. "No, I'd actually like to see expansion of the ecosystem, more players going away from the quasi-oligopoly to more players. And I'm actually seeing the initial signs of that starting to happen. That liquidity provision seems to be starting to move from some of the banks towards other players, so we're going through a lull, but I'm seeing the sign of an uptick in liquidity provision in action. We just need rates to move. Norman, where are you?!"

INFONET@FIA EUROPE

ROUND TABLE: COLLATERAL MANAGEMENT

SPEAKER KEY

TA	Ted Allen, SunGard
KE	Katie Emerson, J.P. Morgan
EH	Eileen Herlihy, J.P. Morgan
PS	Phil Simons, Eurex Clearing
DB	David Brown, Royal London Asset Management
RW	Richard Wilkinson, Contango
KW	Karl Wyborn, NetOTC

Richard Wilkinson This round table covers the collateral management challenges the industry faces as new regulation begins to bite and more instruments move into the cleared environment. Among the questions we shall discuss are the following:

Are people ready for the operational impact of increased movement of collateral? Is there going to be more collateralised trading and how is that going to be managed? Is there really going to be the squeeze on collateral that everybody's been talking about? And what is coming down the track? For example, how will the industry manage the BCBS requirements due in December in relation to the bilateral exchange of initial margin (IM) for trades which will not go into clearing and which fall outside of mandatory cleared products? David, are companies across the transaction chain prepared for the increased movement of collateral?

David Brown We are aware of when the mandatory clearing deadlines are due to be confirmed and the instruments that they cover and that in due course we will be clearing certain types of OTC derivatives along with ETDs. This will result in investment firms running a bilateral OTC programme alongside the cleared programme. It is hard to plan the strategic long-term operating model as there are still some significant unknowns. For example, how many CCPs will offer direct collateral transfer and if they do, will their clearing brokers offer that service to us? I'm not sure that is a given. Additionally, the instrument coverage of the CCPs will evolve over the coming years so investment firms will need to be flexible in their operating strategies.

Investment firms will need to decide whether to develop in-house collateral optimisation programmes or to find a suitable provider for such services. If we build an in-house model we'll have the complexity of building sophisticated programmes that can evolve with the regulatory requirements and market offerings. The actual movement of collateral will probably have a fairly minor impact because most of the collateral settlements process is already automated.

We are curious to find out what the providers will come up with in the collateral space. Some firms are talking to us about their collateral optimisation programmes and some are offering collateral upgrade services. There's even talk of the setting up of collateral exchanges where firms can upgrade and swap collateral with both internal and external parties. Overall, it is very difficult for us to determine how onerous collateral movements will be and what services are required. I would expect services to continue to evolve as requirements become more defined and clients establish more clearly what they would like providers to offer.

RW David has raised a couple of specific points about direct transfer. It is being offered by some CCPs, but will clearing firms offer it?

Eileen Herlihy I believe all the major clearing brokers will offer services where there is sufficient client demand. There is a lot of interest from the buy-side across Europe. But it is a question of an appropriate timeframe. Clearing brokers are still streamlining their operations around the asset attribution type models and making everything as close to straight through processing as possible.

The next natural step is to look at direct pledge type models but, of course, when looking at those models, the appropriate controls need to be in place. How do you manage concentration limits imposed by a CCP for example? Traditionally, that's been at the clearing broker level. In a direct pledge world, would that move to having concentration limits on a client by client basis? As a clearing broker, could you still retain control of the haircuts on collateral if you want to impose your own? There are a number of operational and control hurdles to be ironed out but, given the way that client sentiment is going, I believe in a few years direct pledge will be a mainstream option for segregation.

RW David, what are your thoughts on individual segregation versus omnibus style accounts?

DB A year or two ago most people thought individual segregated accounts (ISAs) would be the way to go but in the last few months we've started seeing the actual cost of the ISA models. The costs can be fairly substantial and this may make firms look at the risk versus cost benefits of some of the other account structures.

It can be a minefield for investment firms because different brokers are offering different pricing structures. Some brokers may have a large account opening charge and a monthly account fee while others may have lower fees but a higher price for each transfer of collateral and that might run up your daily costs significantly. You have to assess the impact of costs across different pricing structures to establish whether individually segregated accounts are beneficial from a cost efficiency perspective.

Vendor solutions also continue to evolve as they try to develop more innovative offerings and drive down their costs. Hopefully buy-side costs will also be driven down as vendors compete across the market. Overall we are not in a great position to estimate how much collateral services will cost or how much collateral will be transferred on a daily basis, due to the many unknowns still to be determined.

EH It will be interesting to see how pricing for individual segregation evolves. Currently CCPs are working on how to make things more efficient for brokers. We don't yet know the end state of the process around collateral movements so it is difficult to know their effect on pricing. A lot of work has been done throughout the industry level to standardise messaging between participants to make sure that everyone is moving in a uniform way, for example with the development of APIs by the CCPs. This would move us away from an operationally inefficient and costly world where somebody has to log into a specific CCP system to move the collateral.

"Everybody has put their prices up and for individual segregation they are fairly prohibitive. Is this because the extent of the operational costs are not yet known?"

Richard Wilkinson, Contango

RW Ted and Karl from SunGard and NetOTC respectively, where are you with your development programmes for a technology offering? Will it be focused on a particular aspect of the market or is it a more holistic approach that could be used by buy and sell-sides to connect and then really bring costs down?

Ted Allen We see two sets of problems, some of which are common across buy-side and sell-side. How to minimise the cost of collateralisation given the increased requirements and then, operationally, how do you deal with the new processes that are required for it? We are very active on both of those fronts. Looking at the cost side, we are developing solutions to provide optimisation tools to price collateral, pre-trade, so that you can better understand where the best settlement location is for a trade if it's cleared or what the best bilateral counterparty for a trade is if it's bilateral. And that is driven very much by how you take into account collateral margin implications and eligibility criteria and how that maps back to inventory and concentration limits etc.

Post trade, we have created tools to allow the optimisation of allocation of collateral and how to automate that process. Optimising the allocation of collateral can be quite different depending on your institution. You'll have your own underlying costs of funding or opportunity costs of the use of the assets. To optimise properly you need to use some quite sophisticated mathematical techniques. It's much more complicated than a simple waterfall type allocation process. To really reap the benefits of optimisation you need to look at your set of requirements and your inventory holistically and to overlay one over the other to work out what the best allocation of the assets is.

On the operational side we recently conducted a survey of 40 clearing brokers around the world to see what their primary motivation or areas of investment were. Two real themes came from that. Firstly, particularly with listed derivatives operations, processes are very manual, particularly for margining. There is a drive for automation and investment there. We are also seeing a trend to combine listed businesses with cleared OTC businesses, which will then seek to look at all the different collateral management silos. We provide a set of tools that allow for as much automation as possible in that process. That means tools for connectivity to the exchanges, the CSDs, the counterparty clients etc and also the workflow tools necessary to process the collateral movements linking in with the optimisation itself.

Karl Wyborn NetOTC is a relatively new company. It focuses uniquely on the un-cleared space or swaps which would be otherwise un-cleared. It has three product offerings, one of which is a CCP for what would otherwise be un-cleared OTC derivatives. It will be an entity regulated as a CCP but with some significant differences to the more conventional CCPs. As we build up to that there are two other services which look to address the legal, operational and capital challenges of the exchange of IM in the bilateral world.

With very few exceptions, only the very largest dealers will be impacted initially by the regulations to be implemented at the end of this year with respect to the exchange of IM. This will progressively become a reality for the buy-side in future years although it's probably not at the forefront of their agendas at the moment.

DB Yes, I think most investment firms will start looking at bilateral IM more closely in a few years time when their funds are more likely to be affected.

KW With respect to the exchange of IM there's a series of upstream challenges that need to be addressed in parallel with what collateral is exchanged, such as what form it should take and the timeliness of the exchange. We have spoken to all the major dealers and there's a clear divide in the market. Some dealers think categorically that the IM will be cash and others think categorically that it will be securities. Personally, I think the bias is towards securities and NetOTC along with many of the dealers endorse the use of tri-party collateral services for moving those securities. It seems like a natural evolution of those services to address the particular challenge with respect to IM, but on a more holistic level what collateral you use is a nice problem to have once you've solved all of the problems upstream. For example, the capital associated with these trades is clearly going to rise significantly.

We look to address the whole gambit of challenges. In many instances people are trying to solve tomorrow's problems with today's tools. At NetOTC we are looking at tools for tomorrow's problems. Those who innovate quickest will survive.

RW ESMA has mandated that prices had to be published. Everybody has put their prices up and for individual segregation they are fairly prohibitive. Is this because the extent of the operational costs are not yet known or because the systems to potentially lower those costs haven't yet been developed?

DB I think the schedules I've seen online are standard charges. My impression is that those charges can be reduced on a relationship basis. Would that be fair?

KW Because these regulations have been dragging on for a long while there's been a huge conceptual debate about the risks associated with certain account structures. But now we are closer to implementation reality is biting and people are looking closely at the costs of segregation and the risks of not segregating. We are moving from concept into reality now in a number of areas. In the un-cleared world people are really being asked what they are prepared to pay for certain services.

EH The market is really focusing on individual segregation when it comes to OTC but we have found that interest in individual segregation for futures has been limited.

RW Is it an unintended consequence of the difference between LSOC under Dodd-Frank and the individual and omnibus regimes under EMIR that people are looking at individual segregation more for OTC than futures because under LSOC you can't have an individual account for futures, it's just about OTC?

Phil Simons One of the main reasons is that futures clients have always used an omnibus structure and there is a big transition to individual segregation including new legal documentation and new account structures. If a client has a global futures broker then they would have different account structures for OTC and futures and between Europe and the US because the US did not include futures under Dodd-Frank and so it has not been prioritised. One of the issues with respect to collateral is that because futures have always worked on a net omnibus basis, providing collateral for the clearing brokers has never been a problem because they have always held more than enough of it and it has mainly been in cash. They have been able to net positions across all their different clients and post whatever is most advantageous to them to the CCP because they had excess cash and securities and they could choose what they wanted to put up.

Also in Europe many clients haven't started to clear and hence aren't posting collateral yet. And finally, we have incredibly low interest rates and low volatility so collateral has not become a problem yet.

Eurex Clearing introduced individual segregation for listed derivatives three years ago but there was very little take up because people were more focused on the OTC side. It also wasn't taken up because not many clearing brokers were offering it as it wasn't as operationally efficient for them as an omnibus account and there wasn't complete straight through processing.

One of the challenges is around collateral management. We have a broad eligibility schedule but a lot of clearing brokers do not offer the same range of eligibility. They want to have a narrower range and apply their own

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haircuts. We also implemented the ability to provide direct collateral transfer last year to address buy-side client concerns about transit risk but the problem is that unless clearing brokers feel fully in control, they don't feel comfortable in using it.

That is why we are introducing a collateral API where clearing members can do all of those things. Developing efficient collateral management services is a long process that the industry has not invested in historically for all the reasons I've mentioned. By investing in collateral APIs, by having the ability to do direct transfer, through standardisation, and an FIA Europe group is working on that, we will improve things.

But what does the future look like? The buy-side has never had to put up with real time intraday margining before. It will come as quite a shock. That will put a huge burden on the clearing broker to fund the client or the clients will have to prefund. You are talking about potentially large and frequent intraday margin calls and they have just an hour to make the margin call to the CCP.

To get everybody to a position where they can cope you will a need a lot of things that have been mentioned. Tri-party collateral management is absolutely essential. But up to now the buy-side has not largely participated in things like tri-party collateral management.

A revolution is going on in terms of people changing their operations models and getting ready for what is going to happen. Eventually, interest rates will go up, volatility will go up and then people will ask themselves if they have enough cash collateral to pay their variation margin. Personally, I think there will be enough collateral in the market. But will it be in the right format, in the right place and can it be moved quickly? I think the answer to that at the moment is no. That's where the problem will come.

With respect to costs I think we will overcome those as an industry through the various groups working on standardisation and the use of tri-party collateral management etc. It is just a question of time in getting systems and processes in place. The big costs are in upgrades and collateral transformation. The balance sheet hit on that is enormous and it's impacted by the leverage ratio in a similar way to the derivatives world. The future probably involves things that people haven't considered yet. For example, securities lending and repo at a CCP with direct access for the buy-side.

> "The market is focusing on individual segregation when it comes to OTC but we have found that interest in individual segregation for futures has been limited."
>
> **Eileen Herlihy, J.P. Morgan**

RW If you did get direct transfer how would Eurex measure concentration limits?

PS Concentration limits have to be the same for everyone. The big issue is wrong way risk. You have to make sure that there's no way that you can have wrong way risk. That's not just for a particular clearing broker, it's for all the clearing brokers and all of their clients. So, for example, if you think of a small European country and a small buy-side firm in that country clearing through a large bank in that country, then you have to be careful what securities they give you issued in that country whether they are governments, corporations or equities. You must set and monitor concentration limits and wrong way risk limits that look across all of the clients, the clearing brokers and all the jurisdictions.

You must also understand that clearing brokers might not have the same risk appetite as others. For example, they might have exposures in other areas and therefore want to impose their own concentration limits which are different from the CCP. They have to have the ability to do that which is why we're introducing our collateral API. Risk departments will have their own view on that and unless they feel they can control and monitor their risks then they won't allow people to take them.

Katie Emerson With respect to the cost and efficiency of moving collateral, at J.P. Morgan we've been looking at central security depository requirements on the holding of collateral as an agent under EMIR Article 47. We are working closely with the London Stock Exchange Group to leverage their Luxembourg-based CSD, GlobeSettle, as our CSD solution.

RW SunGard's collateral offering has analytical and operational tools to communicate with CCPs and CSDs and clearing brokers directly. Are we looking at very sophisticated asset and liability management and is this what this collateral play is all about?

TA Collateral management across silos, treasury and liquidity management, transfer pricing of the assets, securities lending and repo trading all have a fundamental impact on banks' overall assets. There is a clear trend to centralise those things.

To do that you need to break down those silos and get a view of your inventory. What assets are available? What encumbrance is there over them? How long have you got them for? Where can they be used? What value do they have for various different usages? If I want to post a security to satisfy Eurex requirement, for example, what value do I get for that? What price am I going to use? What haircut are they going to use? If I'm putting it into Euroclear for a LCH requirement what's the equivalent there? If I have a position and I can reuse it what is the best way to deploy it given multiple possible uses for an asset? That is an awful lot of information to bring together in one place but a lot of institutions are looking to do it because having an overall view allows you to make centralised and, therefore, more efficient decisions about allocating assets and to have a single view of counterparty risk across the different silos. That's what we are working to provide them with.

PS The major clearing brokers are members of perhaps over 80 different clearinghouses. Each of those will have different collateral schedules, eligibility schedules, haircuts, etc. and their clients are probably giving them the full range of securities. If those clients are giving the clearing broker full use of those securities, which is not generally the case anymore, or if they are providing cash how do the clearers go about optimising them?

Let's say you are up to your concentration limit for Italian government bonds at Eurex Clearing but you have a lot more bonds and could use them at another clearing house. What is the most cost-efficient way for a clearing broker to manage the collateral across 80 different CCPs for, let's say 1,000 clients giving them securities and cash in a huge variety of different currencies? It's just incredibly complex.

KW It is a big problem but it is solvable. You need to be pragmatic. If you extend out into the bilateral world, you could add hundreds, even thousands of bilateral counterparties to those 80 CCPs.

"Having an overall view allows you to make centralised and, therefore, more efficient decisions about allocating assets."

Ted Allen, SunGard

PS Individual segregation does simplify the problem to an extent because you don't have so much choice in terms of what you can do. If these securities belong to one fund manager and he wants to segregate them at Eurex, then that's where they go, and their actually assets are protected and cannot be used.

EH I agree that in an individually segregated account, the clearing broker can't exercise discretion anymore. I would add that clients need to be aware that they need to be incredibly prescriptive to us. For example, if a client currently posts Danish government bonds to its clearing broker and the clearing broker can't post them at the CCP through which the client is clearing, then the clearing broker will find another CCP to which to post them and the client doesn't have to worry about it. Once the client moves to individual segregation, the clearing broker must pass on that exact collateral so the client will have to be aware of the specific collateral schedule of the CCP. Or if a client sends a mixture of collateral, they can't expect the clearing broker to take care of it. They will need to tell the clearing broker what collateral is going where and where their excess should sit. From an operational perspective, clients need to be much more in control and that's why our collateral management business has done a lot of work on tools that facilitate streamlining and optimising this process.

KE With respect to the agency collateral business supporting buy-side clients, the days of managing your CSAs once a week or once a month have gone and market participants are margining every day. They are looking at how to support all their clearing broker requirements and the number of margin calls to be met is multiplying all the time. There will be single currency margining and same day settlements. It's becoming a much more complex landscape for these types of clients. Many of them need to change the types of collateral they're using. Some of them currently only use securities or cash. What will they use in future?

RW Another key difference with individually segregated accounts that many on the buy-side are unaware of when they first look at them is that collateral, whether it's cash or not, is no longer fungible. The clearing broker no longer has discretion so if they rebalance their portfolio and change CCPs under an omnibus structure it comes back to you from the CCP, the position goes to zero, and gets posted somewhere different to where the requirement is. With individual segregation you have to tell the client to tell you to recall the securities or the cash because there's probably no automatic repayment so that the client can post excess margin at the CCP. You then get it back. You notionally have to send it back to the client and then call it back again to post to the other CCP. But direct transfer might shorten some of those transactions.

PS But with individually segregated accounts the clearing broker can still provide collateral transformation and upgrade services if the client agrees. You don't have to pass exactly what the client gives you onto the CCP. It depends on the agreement they have with their client. I think many clients will put in place arrangements to pass through collateral to the CCP.

DB The benefit of individual segregation is that you get your assets back in the event of default (except in extreme circumstances). This means that you need a pass through arrangement with your clearing broker. If you give discretion to clearing members to post something that you haven't given them that benefit is taken away. One problem we believe we're going to experience is the timeframe in which clearing brokers wish us to notify them that we are calling collateral back from the CCP. Some brokers are looking to be notified by eight o'clock in the morning, which can prove very difficult operationally for investment managers with streamlined operational teams.

PS That definitely depends on which CCP you're at.

EH It also depends if it's cash or bonds. Certain CCPs have early cut off times in the mornings for recalling of cash. A clearing broker will have to allow some time between receiving the instruction from the client and then passing it onto the CCP.

PS If you have central bank access, you can leave your cash there and get it back along with other collateral intraday. But if you don't have that access a CCP cannot leave cash just sitting on deposit at a correspondent bank. So they will invest it in reverse repo. Once they do that you might ask for your cash back an hour or two later but they can't get it to you because they have already invested it overnight. It depends on the arrangements that the CCP has for liquidity.

A similar kind of thing occurs with securities. It depends on what the cut off times are that they have on their various investments and how the securities are posted. For example, if you post securities, via a tri-party agreement then those are book entry movements and that gets rid of much of the physical transfer of costs and you can substitute in and out all day long for your securities. You can have your securities back as long as you've got something to replace them with. Also with real-time margins if you've done risk reducing trades you can have your securities back straight away, but it always has to be approved by your clearing broker.

KW But surely that begs the question why wouldn't the buy-side simply deliver its collateral directly to the CCP?

PS That is the most efficient way because then there are no transfer costs.

KW That was a loaded question because in the context of NetOTC where we operate as a CCP there is no risk mutualisation and no concept of a clearing broker. Everybody can join and we encourage them to deliver directly to us the assets they use as collateral. We operate a 'de facto' individually segregated environment as a result of that. But it seems that with respect to clearing there are an awful lot of links in the chain to achieve an outcome that, with the correct legal structures in place, would mean you could just deliver your security directly and perhaps create a more efficient environment.

EH Currently, if you trade futures at a couple of major exchanges and you also trade OTC derivatives, you can just post one set of margin to your clearing broker. In a world where you go direct to all the CCPs, there is a lot more work for clients. The client will have to manage processes at several CCPs rather than having to interact with his clearing broker. The clearing broker currently takes a lot of operational hassle out of things. By going directly to the CCPs, you might solve some issues, but it would be naive to think that you're not adding some complexity in other parts of the process.

KW I understand that for every action there is a reaction but, notwithstanding the complexities, it doesn't seem an insurmountable challenge to be able to deliver directly.

PS Collateral management will be a key differentiator for clearing brokers, CCPs and buy-side firms. A really simple solution to the problem would be to give your clearing broker cash and ask for it to be used wherever needed. That would be cheap and simple for the client but it doesn't solve a lot of their risk management problems, transit risk for example. It's not necessarily the most efficient way to do it but it's certainly the easiest way. At the other extreme, you could have individual segregation with, say, two clearing brokers at four CCPs and you use listed and OTC derivatives. That means you have 16 collateral pools and you have to manage all of that yourself in an operationally efficient way. That's when you would need a really good collateral management system.

Clients are trying to figure out the right answer in terms of how much cash and securities they need to hold for clearing, how many clearing brokers and CCPs they will use and how they will move collateral.

EH Collateral management will clearly become more complex. Some proposals, such as the 50% single issuer concentration limit, could pose challenges if they were to be implemented. For example, if you are a UK LDI manager just holding gilts and if there's a concentration limit meaning that you're only allowed to post 50% of your variation margin (VM) on uncleared trades in gilts, what are you meant to do? Do you have to buy bonds from

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other European issuers and then expose yourself to some more currency risk and the 8% haircut? When clients talk about margin for uncleared trades, given that the initial margin won't impact them day one, they think that they don't have to worry about these rules for years. But of course the rules for variation margin impact everybody from day one.

RW Recent history shows that implementation will probably not be delayed. Everybody was hoping that trade reporting requirements weren't going to include futures. But it got to the 11th hour and ESMA said that there would be no delay. If it's a derivative, you would have to trade report it. And there was a mad scramble to get that done. To hope that regulators will see sense is a very head in the sand, short-sighted approach.

KW There is certainly a desire to build systems and functionality to solve these problems. And the industry could claim that these issues are insurmountable and that there will be a major impact on the market. I guess to some degree there will be, but if you look at the US where clearing's a reality, you don't see markets imploding in any way. There's a lot of work being done under the surface to get it into the position where it is today but fundamentally the market is functioning.

EH But there are some important differences with the US. Firstly, there isn't a choice of segregation models. Clients are devoting a lot of time and energy to examining and choosing the right segregation model. Furthermore, managing collateral for clearing in the US can be much simpler. Clients generally just want to post US Treasuries and dollar cash. So, managing collateral is very different with a European client base that really cares about how its own country's collateral is treated and viewed by both the CCP and the clearing broker. In the US, these challenges are not present.

KW I would turn that round. If these rules had already been implemented in Europe, then, in the US people would think they were lagging behind. They would only have one account structure and as far as collateral is concerned there would be only one asset they could really use while there would be a wide choice in Europe. I don't want to dismiss the complexity but intelligent design, whether it is for un-cleared or cleared derivatives, creates competitive advantage. And if people focus equally on design and build as well as lobbying, then I think we'll arrive at a better spot more quickly.

> "I believe in 2015 we'll see more activity with respect to deciding on solutions and structures for collateral management."
>
> **Katie Emerson, J.P. Morgan**

PS The trouble is, I don't think people have actually done the build yet with respect to collateral management solutions in Europe.

KE People have been a bit sequential in reacting to the regulation. They have worked to comply with the trade repository reporting in order to be ready, for example. I believe in 2015 we'll see more activity with respect to deciding on solutions and structures for collateral management, whether that might be a vendor package, or an in-house build.

KW People have reacted tactically to the changes in the regulatory environment by fixing problems with tactical rather than strategic solutions. In 2015 everybody will be used to the fact that we are living in an age of regulation and re-regulation. MIFID II is on the horizon and people are already talking about EMIR II.

PS Variation margin (VM) is another important thing to look at. In the cleared world it means that there is an awful lot of money going backwards and forwards. Assuming the markets don't always move in the same direction, one day you're in the money and you receive cash and the next day you have to pay a load of money.

A fund manager could leave a certain percentage of the portfolio in cash. And what do you do with that? You can lodge it with the bank and have exposure there or you can use overnight repo or reverse repo. That's why we've been focusing on allowing buy-side clients to become direct participants at Eurex Clearing for Repo. We are doing the same for securities lending and are working on integrating that with the derivatives side because that's where the cash is needed. I think the future lies in giving the buy-side direct access to the funding markets and linking them up with the derivatives markets.

TA A fund manager may want to hold as little cash as possible because that's a drag on fund performance. So tools that a fund manager would look for would be those that would help him simulate what his margin call will be tomorrow, whether that is IM or VM, based on today's trading activity to be able to mobilise non-cash assets as collateral and also determine what trades that might be done to reduce the exposure.

PS You could probably do that for IM, but it's more difficult to predict VM.

DB I think many fund managers in Europe are waiting for clearing to become mandatory. Some brokers are requesting clients to post collateral buffers to satisfy those intraday calls but it's where those buffers would reside that's interesting. We are going into a world of central clearing to try to reduce counterparty risk but if large buffers are placed at clearing brokers that would be contrary to what's trying to be achieved. Effectively firms will be placing cash out on call and then throughout the day those firms may be calling the cash back from the money markets to satisfy CCPs intra-day calls. I'm not sure if it's in anybody's benefit to go down that route.

The alternative would be that firms don't actively manage cash which would result in a drag on performance. The best solution to all this remains to be found. There are still so many unknowns as to what can be offered. In an ideal world it would be great if the legal framework was in place so that firms could just leave their funds' assets in the custody account and not have to move them. If a robust legal framework could be developed so that there were sufficient legal liens over the securities held in custody, then we could avoid the need to keep liquidating or upgrading collateral into cash. If the securities are in custody in sufficient quantities, would we really need this process?

PS You could keep them and lend them and convert them into cash by lending them, as an example.

RW One broker was promoting the idea of lien over securities, as an alternative to having to mobilise the collateral and move it round the system. But they stepped back because it seems that the lawyers decided that it wasn't a perfect umbrella. And when it starts raining you want it open straight away and not wait three weeks for the lawyers to say that it's okay. And without that 100% certainty, that's why taking the lien and immobilising collateral at your custodian or sub-custodian is probably not going to fly in the short to medium term.

PS I think it can work. It requires us to get our ICSD, Clearstream, to open an account with the client's custodian so that clients' assets don't leave their custodian. Additionally most clearing houses are looking to offer some form of client clearing for repo and securities lending where they can transform securities by upgrading them or converting them into cash. In general reverse repo would work well for generating eligible securities for initial margin. The problem with VM is that it goes up and down. One day you need to generate cash and the next you need to invest it. That is why both the securities lending and repo services are required and if the clients use the CCP all of the collateral will be in one place.

DB From a CCP point of view, VM is a zero sum game. But from a client's point of view, you're either long or short.

RW Is it not the case that the cost of maintaining a swap portfolio within a fund or indeed within a bank is going to be principally related to the cost of the capital rather than the cost of any margin?

EH Balance sheet usage at all executing brokers is going to be more expensive and therefore that could be fed through in the bid/offer price to clients. But I do not think this means that clients can ignore the cost of the collateral they post. If clients do not optimise properly then they will end up with a lot of slippage in their portfolios.

If you are a long-dated directional player, then the cost of capital will probably be the thing you're most concerned about. But if, for example, you are a bank trading in many different markets with a portfolio that's very flat from an outright perspective, but with risk in different pools, then managing collateral properly could be critical.

RW My point is that the fractional benefit you might gain from collateral optimisation appears inconsequential in relation to the large number of basis points you pay for clearing.

So effectively the choice is to put an expensive trade into clearing because that particular asset class has now been mandated or not to hedge at all.

DB In the new cleared environment the complexity of building technology solutions for collateral optimisation and the different collateral delivery mechanisms etc will

“It would be great if the legal framework was in place so that firms could just leave their funds’ assets in the custody account and not have to move them.”

David Brown, Royal London Asset Management

inevitably lead to extra layers of costs. I think that overall the cost of a new clearing environment will be higher than the current costs experienced in the uncleared environment.

PS But if there are different OTC instruments that are uncleared they will be hit by capital charges. It’s not going to be cheaper to go bilateral.

TA A bank trading a derivative bilaterally with an end user will hedge it on a cleared basis and incur its costs of clearing there, which it will pass on to the bilateral client.

PS And that is, in some respects, the worst possible scenario because you are then bifurcating your portfolio between cleared and non-cleared products. What a bank really wants to be able to do is to have as much cleared business as possible so it gets the maximum possible netting benefits.

EH This is why pension funds are preparing for clearing even though they have an exemption. Pension funds can clearly see that if even if the trades with them are not cleared, the hedges against those trades will be and this will cause funding implications for the banks. This funding imbalance may have its own cost implications. It’s difficult to isolate one section from the market from the impact of the rules if their counterparties have to comply with those rules.

PS We are looking at which products it makes sense to clear together for exactly that reason. We are looking for complementary products where there is the possibility of margin offsets or netting offsets. Even when we design new products now, we look at what is the most appropriate product to design. Should it be a listed or an OTC product? Which liquidation group would it go into? What offsets could you get with it?

RW We’ve been discussing the overall cost of the trade, including capital, collateral and clearing costs, not forgetting the clearing broker’s minimum account charge. How easy is it to provide a total cost analysis? Is there, from a technical point of view, something that will provide an efficient pre-trade what-if analysis, looking at the CCP to be used, the margin calculation, the collateral cost, etc?

TA We have a tool to aid the pre-trade optimisation decision. It works out the costs that go into the trade and takes into account a choice of clearing brokers, each of them with a choice of CCPs. It will give the user an idea of what the margin impact will be. But you’ve also got to look at the eligibility criteria, what assets you can use and what the funding cost of those assets will be. That becomes an equation of marrying up your inventory management with your simulation tools around the margin calculations.

EH Originally, our margin analytics tool dealt with OTC swaps. Then, as cross-margining became more important, futures margin analytics was included to enable clients to look across the entire cleared derivatives space.

TA We’ve been replicating margin calculations in the listed world for a long time now. With cleared OTC products, not all of the CCPs are willing to open up their models, although Eurex is a notable exception in that respect.

PS We can’t really understand why it’s not a mandatory requirement or why you wouldn’t do it. You wouldn’t buy a car if you didn’t know it had fully functioning airbags.

TA Or if you didn’t know how much it was going to cost to fill up the tank.

KW I think calculating the overall cost of a trade in the uncleared world is absolutely analogous. Institutions and dealers are now contemplating the ‘margin valuation adjustment’ or MVA as a means of calculating, pre trade, the absolute cost that the dealer will incur, and build those into the fee for the swap. In the uncleared world that should not be an insurmountable problem, although there might be an element of putting your finger in the air or best modelling practice attached to it. And that’s really where the rubber hits the road, when you call your broker to try to execute a swap and you’re given the series of options. Or perhaps you’ve already negotiated a series of options in your legal agreements, and then you’re told what the cost is. I’m a strong believer that the market will decide and costs will be one of the primary criteria. Everybody, as far as I can see, is trying to work out what that number is.

> “ The analytics model needs to be built with the flexibility to account for the different pricing structures. Parameters need to be able to be turned on and off.”
>
> **Eileen Herlihy, J.P. Morgan**

RW With respect to best execution, and by that, I’m referring to who is it best to actually clear through, do current models currently factor in each client’s pricing structure with a particular broker? For example, if I buy a 30-year swap, one broker may be offering an initial margin, or percentage of an initial margin on an annual basis while another may have been offering a pure one-off ticket price. You don’t know how long you will hold that swap for. I can see how you can do best execution for the constants, i.e., the CCP fees etc, but how do you deal with different pricing structures?

TA Obviously, you need to understand the core of the CCP model and then whatever add-ons the brokers may charge. It will be individual to each broker and each client.

EH The analytics model needs to be built with the flexibility to account for those different pricing structures. Parameters need to be able to be turned on and off.

PS Best execution prices include the cost of clearing and settlement under MiFID.

RW Yes, it’s going to be interesting, because trading futures or cash products you have the bid offer spread, a certain amount of margin and other clear parameters so you can work out the real best execution. With a cash product where you have multiple trading venues it’s very easy to get that total cost because you know your cost of settlement through Euroclear or Clearstream.

But if you’ve have capital, collateral and transformation costs and VM through a securities lending programme to generate cash every day, those components are so complicated, that the bid/offer spread almost becomes meaningless. Would that ultimately lead to a standardisation of models available that will, then, drive the OTFs back to the narrowest bid offer spread and provide best execution in that way?

PS Will there be a different bid/offer price depending upon whether the executing broker and the clearing broker are same? For example, Bank A might quote me a price but I intend to clear through Bank B. It’s whatever price Bank A is comfortable with quoting. From the client’s point of view their counterparty is their clearing broker. So the bid/offer spread, from the executing broker’s point of view, is purely the cost of capital that they are prepared to quote at, and it depends on which way round their book is. So will there be different prices?

EH The clearing broker won’t know with whom the client is trading. The point is that the client needs a tool that takes into account both clearing and execution costs as you say

PS Yes, exactly.

EH In many cases it won’t be the same at all, as clients diversify their execution brokers. We’ve been talking about tools that help you decide how you allocate trades among your clearing brokers, among the CCPs. Once the initial margin rules for uncleared trades come in, then you’ll also have to extend that conundrum to your uncleared trades. For example, should I send this trade to bank A or bank B and what is my collateral position at each of those? Once again, the universe gets increasingly complicated, whether you’re looking at two clearing brokers, two CCPs, or looking at all of your executing brokers.

PS But the conundrum for some fund managers is that they might be executing a block trade for five, six, 10 funds at the same time, which they then have to allocate afterwards.

EH Block trading may become more difficult depending on the profile of the underlying funds. What if some funds choose individual segregation and some don't?

PS And also what if some funds are US persons and some funds aren't US persons? That would be yet another different model.

KW But haven't we said that the simplest route to market would be a cash only, omnibus account? I am not saying that's the way to go but it's a paradigm that doesn't exist in the pre-clearing environment. In the new environment perhaps the buy-side and other market participants can start taking more risk within their portfolio, not with respect to the positions they take but with their approach to clearing, collateralisation and other things of that nature. Because often the path of least resistance might be one which is moderately more risky than some of the other options available.

EH Clients may feel comfortable with the gross omnibus type model in OTC as the safer option. Gross omnibus models offer more protection that the traditional futures style net omnibus model. But the path of least resistance may be to go with the safest option.

KW Do you think that relative performance can be attributed to the cost of collateralising and margining?

RW I spoke to a large European-based fund manager about individual versus omnibus segregation or a family of accounts just for them versus the plain vanilla current futures omnibus account. And they said they would go to individual segregation. I said that might be quite expensive but they replied that they would not be able to justify omnibus segregation to the trustees if something went wrong. It seems that they are following the path of least resistance from a career and reputational perspective.

But now the costs are actually coming through, perhaps that conversation with the trustees might be slightly easier. Many fund managers will start to recognise that it will be a drag on performance, especially if it's being charged to the funds. Those conversations will probably be a little more balanced than they were a year ago.

KW In the uncleared space, where you don't have a CCP in the middle, the risk versus reward model is still prevalent. You still choose very carefully which counterparties you do business with. The provision of IM is, to some degree, the cost of doing business. The IM you collect is the risk mitigant for you, but it's not your cost. Any vehicle which lowers that cost wouldn't necessarily corrupt that risk reward model, which I think will still prevail.

> " I'm a strong believer that the market will decide and costs will be one of the primary criteria. Everybody, as far as I can see, is trying to work out what that number is."
>
> **Karl Wyborn, NetOTC**

PS I think the market will look at the different non-cleared OTC, cleared OTC or futures instruments available. We've already got three different flavours of swap futures out there. Will people start to use different products to hedge their risks for these very reasons?

RW Looking at the type of hedges that some insurance funds might make with, say, 50-year OTC swap futures, will there ever be the liquidity in a swap that could give you that same hedge? That's one of the concerns in moving everything to an ETD basis.

PS Providing liquidity in an ETD world is probably the easier of the challenges as seen by new product launches historically. You need to get enough participants with natural opposite interests and market makers who are prepared to provide that additional liquidity. Our recent successful launch of BTP and the OAT futures is a good example of that, although we haven't yet seen liquidity in the different swap contracts, although it is starting to pick up.

EH I'm still undecided with respect to swap futures. The contracts that have been launched over the last few years have really struggled to get off the ground. Will the buy-side support them sufficiently to incentivise the dealers to get behind them?

PS Previously, we didn't have mandatory clearing but also some dealers may not have supported swap futures because they had a large swaps business. Given the way that the leverage ratio and various other capital costs kicked in there is less of an incentive for people to provide liquidity in the actual swaps themselves and so could be more incentive to use futures now.

EH It's interesting that someone might accept the basis risk between a swap and a 50-year future rather than deal with the complications of OTC clearing. For me, that is a much more significant risk than say for example the transit risk of using an asset attribution model in a clearing construct. People spend a lot of time talking about operational risks within clearing, but then at the same time, seem to be seriously considering swap futures instead of swaps. It is interesting to see the weighting clients are putting on various risks.

KW I agree with you but I guess different people within the bank look at basis risk versus the operational risk.

PS Much of it will come down to how well the market can provide solutions for all these problems. And that would mean providing OTC IRS at a reasonable price. Then, you might ask if there is a need for some of those futures contracts.

RW Coming back to collateral, where do you think we will be once mandatory clearing kicks in?

KW This is a long game, so with respect to collateral, I think the whole concept of a crunch is misplaced. Extrapolating from industry experience in the US, there will be a relatively modest increase in the use of initial margin, initially against cleared and uncleared OTC derivatives. The costs of margin will be more effectively incorporated into the cost of the trade from the outset. There is a lot of focus on that.

And I think we will see innovation in all areas. We are only just starting to get a glimpse of what tomorrow's tools might look like to make the markets function in the way that they need to for the benefit of all participants from market professionals to the general public with their pension funds.

TA I think we'll have moved further along the path from tactical solutions to strategic solutions. Judging by my pipeline, I see a lot of interest in the re-evaluation of collateral management infrastructure on the operations side, on the inventory side and on the optimisation side.

PS I predict a wider use of securities as collateral. This year companies will be putting collateral management solutions in place. They will be looking at the use of either a collateral agent or tri-party services. They will be focusing on creating a collateral function within their firm around securities lending and repo, if they don't have one already. And they will be looking at more proactively managing their collateral across asset classes in the world of mandatory clearing.

DB As I said at the beginning, there are still many unknowns. It will be an interesting year for the investment management world. When mandatory clearing comes in, the fund managers actually managing those funds will get a good grasp of the effect it will have on fund performance. That's when there will be a heightened interest in the services that are being developed at the moment.

EH I would expect to see a consolidation of players in the market, both on the clearing and the collateral management side. J.P. Morgan is one of the few firms looking to future proof its business by integrating those functions because we realise that clients will have to look at things holistically. Of course, building those businesses requires a lot of investment and banks will get smarter at allocating costs back to the underlying businesses. Clearing brokers who haven't built in their full costs will find that it's harder to take part in businesses like this at a time when there is so much regulatory change. It is very expensive to build these businesses and to keep them as state of the art as everything evolves.

KE We may see some providers in the collateral management space exit the market as solutions become more sophisticated. Optimisation and analytic consolidation services will gradually be offered together. We will also see a much broader use of tri-party, beyond what it's used for now. It will no longer just be used for repo and stock loan. By the end of this year, we'll see it being used for the segregation of margin for uncleared trades. Tri-party agents are seeking ways to expand their products to support the change in business. Finally, I think the role of the CSDs will become more apparent in terms of the value and the cost.

RW I don't think there'll be a collateral squeeze. It's going to be about mobilising collateral and moving it to the right place. Some ICSDs are developing a 'collateral highway' which Euroclear is involved in. And that ties in with increasing use of tri-party. I think there will be consolidation among clearing brokers and technology companies because people won't necessarily have the money to stay in what is becoming a very expensive business. But the unintended consequence of that is that risk will be concentrated among fewer GCMs. Just in the last six months, I believe that's gone from over 100 to under 80. This concentration of risk at clearing broker level is not a consequence that the regulation was meant to achieve. If cleared is better than uncleared, the unintended consequence is that risk is concentrated on less clearing brokers, whether that is for fund managers or second-tier banks or brokers that don't have the capital to join the CCP directly.

PS On the other hand there are more and more banks going direct to the CCPs. We get several new enquiries each week for direct clearing membership, not to start client clearing, but to do self-clearing.

KW Is there a chance the buy-side will become direct clearers?

DB I don't think that will happen. It's just too expensive and moves you away from your main function. I think the risks and costs involved in becoming direct clearers would be outside most buy-side firms' risk appetite.

PS We are certainly being approached to look at alternative clearing models to allow the buy-side to participate more directly with the CCP, in particular so that they could act as principal to the trade. And that raises a question about the evolving role of the clearing broker in that model?

We already have direct access models today for both securities lending and repo. We call it 'special lender licence' or 'special repo licence'. Can that be extended to cover the derivative side so that people are comfortable with it and it satisfies a real client need? And can it be done in a way that doesn't disenfranchise existing participants? It's a topic that is very high on our agenda. I know other CCPs have been approached, as well.

RW In effect it looks like an agency model. The GCMs become agents rather than principals.

PS The back-to-back, riskless principle is an agency model. It's just not treated like an agency model.

RW Most fund managers are going through a process of not wanting to be principal to any trades. They are trying to get an agency agreement for everything. It would be another change in culture to go to being a principal to trade.

> "People are looking into alternative ways of managing their collateral and alternative ways of trading and clearing. That's inevitable."
>
> **Phil Simons, Eurex Clearing**

KW With the NetOTC model everybody is a member but at the point of default only those entities that have traded with the defaulting party are impacted. The first thing we do is tear up the corresponding contract with the surviving member, thereafter through a synchronised and prescriptive close out process we reintroduce liquidity into the market via 'crossing' transactions, which are, in effect, a series of macro hedges executed by surviving members. Thereafter NetOTC gives back IM to the remaining solvent parties to actually do their own work out and not rely on a default management group.

The point is that the conventional model of a CCP is being challenged. In some instances with illiquid, non-standard trades a conventional CCP simply doesn't fit the market dynamic. But of course, others could adopt a similar model.

PS The main point is that because of the capital rules, the difficulties and costs involved in building all these systems, people are looking into alternative ways of managing their collateral and alternative ways of trading and clearing. That's inevitable.

CLEARING IN A DAY

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FIA EUROPE NEWS

RESPONSES TO REGULATORY PAPERS AND POSITION PAPERS

March 2015 **FIA Europe** worked with member firms and maintained a dialogue with regulators in order to submit its responses to ESMA's consultation paper on MiFID II/ MiFIR.

February 2015 **FIA Europe** response to ESMA consultation paper. Review of the technical standards on reporting under article 9 of EMIR.

Jan/Feb 2015 **FIA/FIA Europe** MiFID II Special Report Series.

January 2015 **FIA Europe** responds to Fair and Effective Markets Review.

NEWS

March 2015 **FIA Europe** held a successful conference on MiFID II, bringing together an impressive list of speakers and a full house of delegates to hear presentations on the key areas of the directive and regulation that will have the most impact on the listed derivatives industry.

February 2015 **FIA Americas, FIA Europe and FIA Asia** launched the new FIA.org. One site for global access to the issues, news and events that impact you and your business

NEW MEMBERS

We are pleased to welcome the following new member: **Schulte Roth & Zabel International LLP**

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FIA EUROPE EVENTS CALENDAR

FIA EUROPE'S CLEARING IN A DAY – AN INTRODUCTION TO DERIVATIVES CLEARING

FRANKFURT ~ TBC

FIA Europe's one-day conference, Clearing In a Day – an introduction to derivatives clearing, provides essential insight into this area for anyone entering the new world of clearing, whether in an operations, compliance, legal, regulatory or other capacity, on the sell side as well as the buy side.

IDX 2015

TUESDAY 9 & WEDNESDAY 10 JUNE ~ THE BREWERY

FIA and FIA Europe are pleased to present the eighth International Derivatives Expo. Last year's event welcomed a record number of delegates and included exhibits showcasing the latest in products, services and technology for the derivatives industry, 25+ sessions with high-profile speakers, information packed workshops and valuable networking opportunities.

IDX GALA DINNER 2015

WEDNESDAY 10 JUNE ~ THE ARTILLERY GARDENS AT THE HAC

FIA and FIA Europe are pleased to confirm the IDX Gala Dinner will once again be held in aid of Futures for Kids. The Dinner also provides a valuable networking opportunity for those attending IDX and the international financial community.

2015 POWER TRADING FORUMS

THURSDAY 26 MARCH – REED SMITH

2015 COMPLIANCE & REGULATION FORUMS

THURSDAY 28 MAY – HSBC

Topics to be confirmed.

FUTURES FOR KIDS CALENDAR

15 MAY FFK DAY & WALK TO WORK, LONDON
21 MAY – QUIZ NIGHT, MINSTER EXCHANGE, LONDON
3 JULY – GOLF DAY, BROCKET HALL, HERTS

Visit www.futuresforkids.org.uk

Futures for Kids

UPCOMING INFONET EVENTS

22 APRIL 2015 – GROCERS' HALL
TRADING & EXECUTION ISSUES IN LISTED DERIVATIVES
JULY 2015 – GROCERS' HALL
OCTOBER 2015 – GROCERS' HALL
JANUARY 2016 – GROCERS' HALL

The core four-event programme is nominally divided up as follows:

- Trading and technology
- The pre- and post-trade environment
- Innovation – product, process and place
- State of the industry – the outlook for ETD businesses

Senior management from FCMs, exchanges, clearing houses, proprietary trading firms, vendors and end-users discuss their latest issues. Further information available shortly.

Who can attend?

This event is open to executives at FIA Europe member firms and to specially invited guests of FIA Europe and InfoNet Sponsors

For more information on all events, including sponsorship opportunities, please contact Bernadette Connolly on bconnolly@fia-europe.org or +44 20 7090 1334

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IDX

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