New business and operating models for derivatives

Adapting to and benefiting from shifting regulatory winds

Deloitte Center *for* Financial Services

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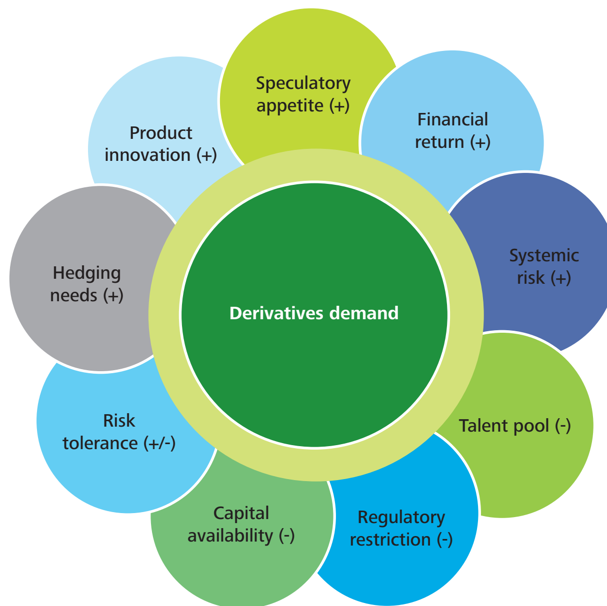
For years, swap dealers benefited from growing demand for over-the-counter (OTC) derivatives, attractive spreads, and limited regulation. With favorable winds, swap dealers capitalized on the opportunity with a steady supply of new products and services.

The situation changed during the market turmoil in 2008 and was amplified by the subsequent global regulatory response. Today's OTC derivatives market is characterized by higher capital requirements, lower leverage ratios, and tighter spreads. These changes, alongside regulators' and market participants' expectations of greater transparency and enhanced business conduct standards, have resulted in a market increasingly bifurcated between highly standardized and liquid OTC cleared products, and more customized (in typical parlance, "bespoke") structures with lower liquidity but higher margin potential.

Exhibit 1. Drivers of derivatives demand



Source: Deloitte & Touche LLP

+ indicates a positive impact on demand for derivatives

- indicates a negative impact on demand for derivatives

To operate in this changed OTC market environment (see Exhibit 1 on drivers of derivatives demand) between "environment" and "swap," swap dealers are forced to be more selective about what business models they pursue and how they allocate resources. As regulations become clearer, and structural market changes brought forward by those regulations begin to take root, senior managers need to assess their firms' competitive advantages and attempt to optimize capital and resources. Today, swap dealers are required to be particularly disciplined in their approach as they choose what products to offer, what clients to serve, and in what markets they can meaningfully compete.

In this context, firms' leaders should support their business choices with the right operating model to deliver more optimal performance. These operating models include the structures governing the organization, data, processes, and enabling technology infrastructure.

Careful design and execution of business and operating models can enable derivatives dealers to unlock value and gain access to new revenue streams. This paper provides insights into the potential business strategies to remain competitive in the current OTC derivatives market environment and outlines some of the key considerations to implement an operating model in support of superior returns.

High regulatory stakes

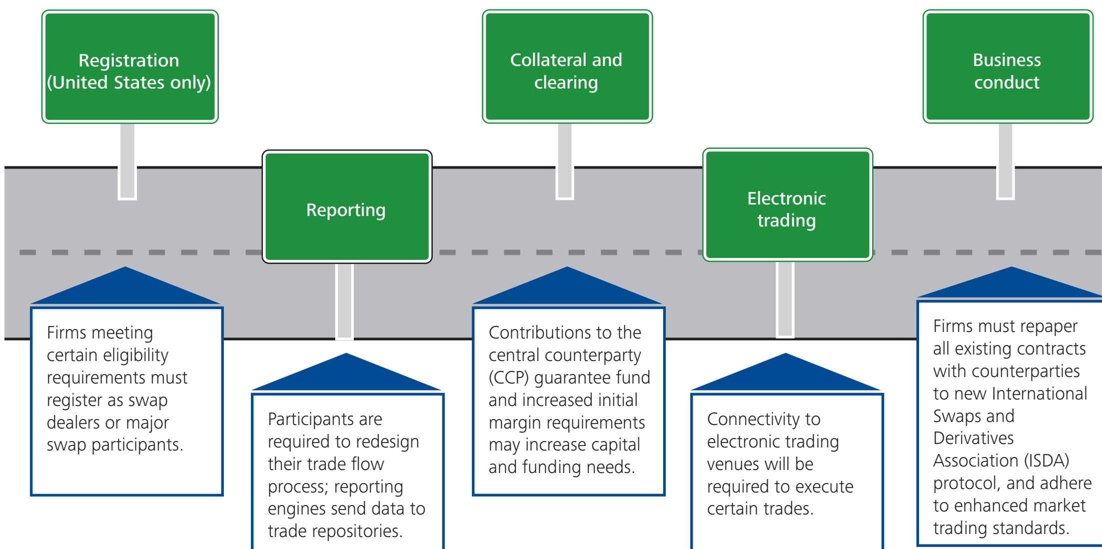
Practices in the OTC derivatives market have been linked to the financial downturn: limited pricing transparency, high leverage, hidden risks, and concentrated exposures to a few market participants, among other factors, are thought to have increased systemic risk.[1] As a result, global OTC market reforms have received a good deal of attention. The principal aim of the new regulations is to reduce systemic risk through increased standardization, central clearing, improved business conduct standards, and the use of electronic trading platforms.

Following recommendations made by the G-20, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and the European Market Infrastructure Regulation (EMIR) rules (among other global regulations) seek to dramatically reshape the way derivatives are structured, marketed, and traded (Exhibit 2). (See the recent Deloitte MCS Ltd. report "CFTC and EU OTC derivatives regulation: An outcomes-based comparison" for more details.)

The journey to implement these changes globally is likely to be long and challenging, but some progress has been made. As an example, mandatory electronic trading of certain types of interest rate swaps and credit default swaps on swap execution facilities (SEFs) began in the U.S. markets in February of 2014. Approximately 76 percent of U.S. interest rate swaps, and 99 percent of credit derivatives, are now centrally cleared.[2] The percentage of cleared OTC transactions is likely to increase over time as regulation extends into other asset classes. The combined effect is a reduction of trading convention differences between OTC and exchange traded derivatives (ETDs).

However, this trend is not uniform across the globe. Reflecting the differences in national regulations and markets, the share of centrally cleared transactions differs significantly across countries.[3]

Exhibit 2. Common requirements of derivatives reforms[4]



[1] "Implementing OTC Derivatives Market Reforms," Financial Stability Board, October 25, 2010.

[2] CFTC Weekly Swaps Reports, Average of weekly figures from March 21, 2013 to April 18, 2014.

[3] Jacob Gyntelberg and Christian Upper, "The OTC Interest Rate Derivatives Market in 2013," BIS Quarterly Review, December 2013.

[4] Deloitte, "OTC Derivatives Reform: This is just the beginning…," 2013, http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/US_FSI_OTCDerivativesReform_021413.jpg.pdf.

Impact on business models

Regulatory and market reforms have three main effects on traditional derivatives dealers.

Margin pressure

Reforms in the OTC derivatives market have put substantial pressure on swap dealers' margins.

Central clearing, higher collateral, the shift of derivatives activity to standardized futures exchanges (the "futurization" of swaps), and increased market transparency have reduced bid-ask spreads. This is impacting revenue projections for swap dealers, with potentially acute consequences: holding companies in the United States alone made almost $54 billion in trading revenue from derivatives in 2013.[5]

At the same time, it is evident that derivatives trading has become a more expensive proposition. For instance, research by the EMEA Deloitte Center for Regulatory Strategy suggests that regulatory reforms will increase the total annual cost of derivatives trading by €15.5 billion in the European Union (EU) through new margin requirements, capital charges, and other compliance costs.[6] And, consequently, the paper goes on to say that these cost increases will lead dealer banks to review the products they offer and possibly withdraw from certain asset classes.

More stringent compliance requirements have strained swap dealers' capital, as well as operational and technology budgets. When the pressure to increase performance builds, businesses initially tend to react by adopting cost-cutting measures, affecting compensation and further cutbacks in infrastructure investments. When returns are low, organizations will shift resources to business with a higher return on equity (ROE) and return on assets (ROA). Dealers are not unique; they are strategically choosing which derivatives businesses to be in, and those choices need to be backed up by an operational approach that allows them to sustain their ROE and ROA at acceptable levels.

Unbundling of services

Traditionally, financial institutions developed and benefited from connected or integrated services (e.g., market making, trade execution, clearing, settlement) with a common or shared supporting infrastructure. For some firms, new regulations are breaking the value chain into separate components, increasing the costs of supporting each service and potentially allowing new participants and third parties to disrupt and capture traditional flows.

The impact of unbundling is significantly affecting the ownership, control, and revenue structure of key trading, clearing, and reporting operations. As a result of increased regulatory compliance and processing complexity, selected utilities, information providers, custodial firms, and CCPs are expanding their traditional capabilities; examples include middle-office outsourcing, trade repositories, clearing, and electronic execution venues.

Perversely for swap dealers, unbundling has created an additional number of transitional challenges that can further impact liquidity. Uncertainty in clearing and trading are primary examples; with multiple participants involved in a clearable trade (SEFs or their European equivalents, multilateral trading facilities (MTFs) dealers and CCPs), it is still unclear who is responsible and who will bear the losses for a trade that fails to clear on time.

Fragmentation and specialization

Finally, derivatives players face an increasingly fragmented market, both within and across jurisdictions.

Within the United States, inter-operability among CCPs has not been allowed by Dodd-Frank. Inter-operability, in the words of European Central Counterparty N.V., would "provide trading firms with the ability to select a CCP of their choice from a number of valid alternatives. To inter-operate, CCPs establish arrangements with one another so that a user of one CCP can execute a trade with a counterparty that has chosen another."[7] Lack of interoperability, coupled with margining requirements that are set at the CCP level, may affect pricing strategies and market liquidity.

[5] Office of the Comptroller of the Currency (OCC), Quarterly Report on Bank Derivatives Activities, Fourth Quarter 2013.

[6] Deloitte EMEA Center for Regulatory Strategy, "OTC Derivatives: The New cost of trading," Deloitte LLP, April 2014, http://www.deloitte.com/view/en_GB/uk/industries/financial-services/26a04a9977c15410VgnVCM1000003256f70aRCRD.htm.

[7] "Q & A," European Central Counterparty N.V. (EuroCCP), http://euroccp.com/qa/interoperability.

Geographic fragmentation may present additional challenges to swap dealers. Lack of uniform regulations can reduce liquidity in markets that are perceived to have the most onerous regulations, potentially raising concerns regarding concentration risk in areas where specific activities cluster.[8]

Key approach and timing differences are likely to play a role as well; as an example, European regulations do not yet mandate electronic trading. That said, the Commodity Futures Trading Commission and the European Commission have taken steps to align the framework for SEFs in the United States and the European equivalent, MTFs.[9]

Another potential outcome of this fragmentation is an increase in swap dealer specialization, which in turn could lead to the creation of product and service clusters in certain jurisdictions.

Though these general outcomes are widely expected, participants in the OTC derivatives market — whether swap dealers, exchanges, trading platforms, utilities, CCPs, or end users — do not yet have sufficient clarity in a number of areas. Will OTC trading volumes decline or grow as a result of recent changes? Will the futurization of swaps gain further momentum? How much of a threat will new players pose to traditional derivatives players as traditional boundaries erode? No matter what the responses are, change is all but inevitable.

The case for change

The initial dealer response to the changing market environment included changes to trade execution, reporting, and clearing processes to comply with new regulations; this phase is well advanced and in some jurisdictions largely in place. That said, the job is far from complete: quick patches and tactical solutions are commonplace.

Swap dealers are experiencing challenges moving from ad-hoc fixes to strategic, scalable, and robust solutions that are flexible enough to continue to address upcoming compliance requirements while maintaining their existing competitive advantages. Some are finding it difficult to move processes to a "business as usual" environment, while others have been forced to embed costly process-controls to ensure or monitor compliance. The majority has yet to decide how to rationalize businesses that do not generate income and how to select a strategy that maximizes returns.

To help firms address these difficulties, the remainder of this piece will discuss priorities that firms should consider when rethinking business and tailoring their operating models to enable the desired strategic shifts. (Please see the Deloitte Center for Financial Services publication "2014 Capital Markets Outlook — Repositioning for growth: New models for a new era" for additional insight on the transformation occurring in the derivatives marketplace.)[10]

[8] "Cross-Border Fragmentation of Global OTC Derivatives: An Empirical Analysis," ISDA research note, January 2014.

[9] Andrew Ackerman and Katie Burne, "U.S. Strikes Deal With EU on Trading of Swaps," *Wall Street Journal,* February 12, 2014.

[10] Deloitte Center for Financial Services, "2014 Capital Markets Outlook — Repositioning for growth: New models for a new era," http://www.deloitte.com/view/en_US/us/Industries/Banking-Securities-Financial-Services/73e3415ec5e23410VgnVCM3000003456f70aRCRD.htm.

Rethinking business models

Faced with reduced margins, unbundling of services, and fragmented markets, how should derivatives dealers continue to adapt? How might firms make progress in their strategic business planning in the face of complex extra-territoriality rules and different regulatory regimes? The first step in addressing these questions is to consider how these trends will impact the structure of the OTC market and assess firms' potential response scenarios.

With the "electronification" of the OTC market, execution revenues are expected to continue to erode and spreads will remain narrow. This is likely to result in increased focus on scale and client-clearing businesses in both listed and OTC derivatives. In contrast, uncleared OTC derivatives could end up becoming a more attractive alternative for the dealers and clients interested in bespoke structures that can meet their unique hedging needs or provide hedge accounting benefits.

Declining revenues may be offset by increased demand for more customized products and the associated higher margins they would command. As a strategy to preserve revenue and increase "client stickiness," OTC dealers can also consider providing hedging and risk management offerings to their clients.

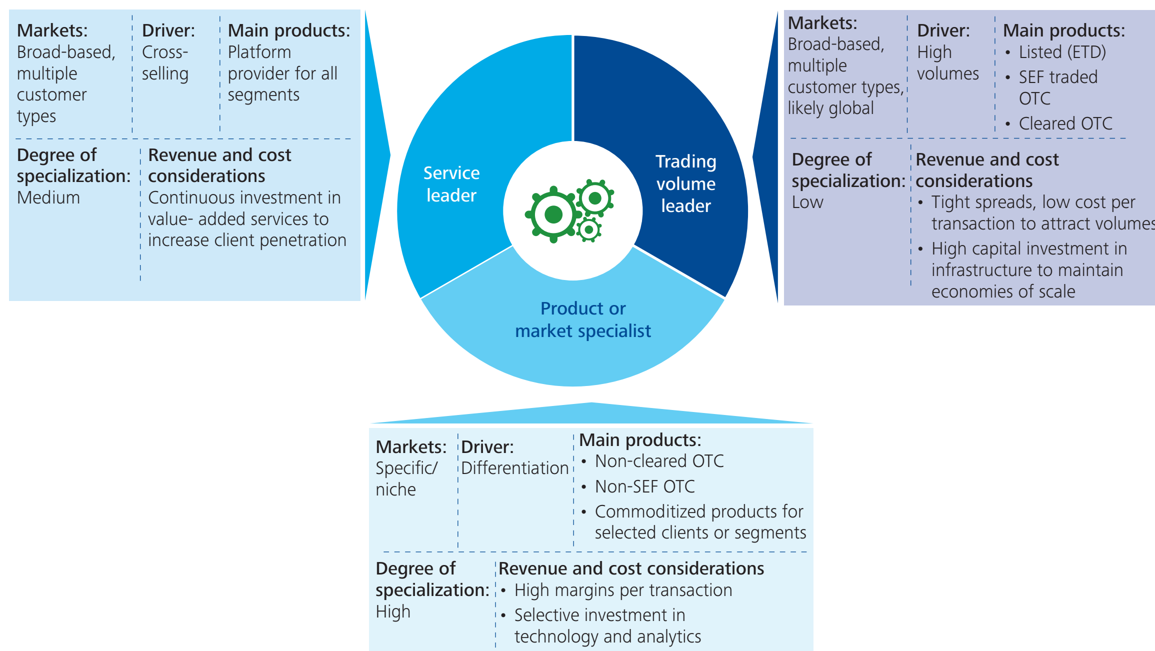
Key alternatives

The pressures described above could be expected to drive derivatives dealers toward one of three core business models (Exhibit 3). At the most basic level, firms will need to decide whether their competitive advantages lie in:

- Competing on volume in standardized, cleared products
- Becoming a leader in an end-to-end offering of complementary services
- Specializing in certain products (e.g., standardized or bespoke), geographic markets (e.g., USA or Europe), or customer segments (e.g., institutional investors or end-users)

Each choice will generate a wide range of subsequent decision points, from investment in infrastructure to client service strategies. Primary business models include volume leaders, service leaders, and product or market specialist.

Exhibit 3. Primary business models for swap dealers



Volume leaders

Some dealers can aim to become volume leaders in the highly standardized, liquid, and cleared OTC derivatives space. In this model, the high fixed costs needed to support an efficient and competitive electronic trading and clearing operation may act as a natural barrier to those constrained by unsuitable legacy capabilities.

This model will attract a large number of providers, with multiple end-users. A strong brand and global reach will be crucial to succeed. Also, close monitoring of costs and the ability to convert operational efficiencies into savings for clients will become more important as margins continue to erode due to strong competition.

Early interest for this strategy could result in fierce competition that might demand further investment in technology and perhaps even a transition to high-frequency trading in the derivatives market. Those that cannot do so successfully will likely be forced to choose one of the alternative models described below.

Service leaders

Other dealers are considering focusing on bundling complementary services. The main characteristic of this model is the differentiation of offering an end-to-end and high value-added suite of services such as collateral optimization, delegated reporting, and risk management analyses.

Since the inception of SEFs in the United States, clients have favored request for quote trading over central limit order book methods; this suggests that clients continue to value the historically relationship-driven businesses and related value-add services. Cross-selling is made possible by offering competitive pricing to clients for an opportunity to grow market share from some of the other related revenue streams.

Product or market specialists

Some swap dealers will consider shifting their business to focus only on certain products, customers, or geographies. Dealers ready to make a market for less liquid and less standardized OTC derivatives segments could command high prices to compensate them for taking higher capital charges as well as the costs associated with riskier transactions. These organizations will likely require a higher degree of specialization to attract clients seeking boutique-type brands and experiences, especially for bespoke trades. Higher transaction margin potential could serve as a balance to collateral and capital costs, making this model an effective alternative to broad-based scale.

Assessing which of these business models and strategies is appropriate for a given institution will likely be complex and will likely result in hybrid models, including adaptations of or derivations from the three main themes noted. As firms assess options, they should carefully consider their current market position, return on capital expectations, service capabilities, and overall (i.e., not limited to derivatives) firm strategy; they will also likely need to take into consideration more subjective elements like brand perception, as well as their financial and regulatory risk appetite and culture.

Firms should also make sure they have — or can build — the supporting operational infrastructure to turn their chosen business model into a sustainable operation that can translate some of the success into value to their clients (e.g., lower costs, more services, more tailored products in each model respectively).

Increased market collaboration

Dealers' strategies will be tied to overall industry capabilities. Historically, swap dealers have operated independently with limited incentives for collaboration with others in the market ecosystem. There is now increased convergence between ETDs and OTC products, as exchanges and new entrants (particularly SEFs) are increasingly entering areas once dominated by dealers. Increased use of vendors, middleware providers, and market utilities might make strategic and economic sense.

Derivatives market participants in their current roles as swap dealers, major swaps participants, futures commission merchants, or clearing members have multiple opportunities to explore collaboration with other market infrastructure players and service providers. There are several examples of efficient marketplace partnerships that derivatives dealers can build upon. Similar relationships have also the potential to alleviate existing challenges like the certainty of clearing and/or certainty of trade effect.

Tailoring operating models to the business strategy

Even the best business strategy is doomed to fail without operational cohesion — that is, a firm’s ability to execute the chosen strategy by designing and implementing a supporting operating model. When designing and refining these operating models, organizations should pay particular attention to their operations, infrastructure (including data, process, and technology), and talent.

Building the right infrastructure

Most firms have already invested in basic operational and technological capabilities to comply with new practices and regulatory requirements, but much remains to be done to operate efficiently. The main priority for derivatives dealers should be integrating disparate trading platforms, streamlining front-to-back processes, and cleansing real-time and reference data feeds.

Some areas with potential for business-value creation are particularly ripe for increased operational and infrastructure investment (Exhibit 4). For example, as firms shift to a more holistic view of their clients and services within their chosen strategy, investments in analytics may unlock efficiencies in portfolio collateralization. Improving collateral efficiency will be crucial as new rules continue to impact margins. The Bank of England has estimated that total new margin requirements will be between $200 and $800 billion once the full impact of OTC reforms are felt — making increased efficiency an essential concern.[11]

Financial market participants have already heavily invested time and resources in compression of outstanding portfolios; compression also relies on shared infrastructure and tools. Portfolio compression helps reduce redundant trades, resulting in lower gross exposure while maintaining new exposure and risk profiles unchanged. Participants benefit from lower capital and collateral, and CCPs benefit from associated lower risk and capital needs.

Exhibit 4. Derivatives transaction-processing life cycle -- potential improvements by selected category

<table>
<tr><th></th><th>Pre-trade</th><th>Trade execution</th><th>Capture and confirmation</th><th>Collateral management</th><th>Clearing</th><th>Portfolio and trade compression</th></tr>
<tr><td>Technology and processes</td><td>Valuation and pricing to account for risk and margin management requirements</td><td>Order aggregation and smart routing</td><td>System rationalization across asset classes and products</td><td>Inventory management, optimization, transformation</td><td>Legacy OTC and ETD platform rationalization</td><td>Internal and external reconciliation and exception remediation</td></tr>
<tr><td>Data management and analytics</td><td>Reference data for client onboarding, know-your-customer requirements, and risk
Sophisticated pre-trade pricing analytics (e.g., credit valuation adjustment charges, overnight index swap discounting)</td><td>CCP margin requirements and pricing comparison</td><td colspan="3">Linkages to counterparty credit risk and collateral management
Approved capital and internal model for margin/cross-margin calculations</td><td>Connectivity and industry compression capabilities</td></tr>
<tr><td>Risk management</td><td>Integration with counterparty credit risk management processes</td><td colspan="3">Desk-level and firm-wide risk aggregation on demand (i.e., intraday)
Liquidity bifurcation management (U.S. vs. non-U.S.)</td><td>Pre-trade margin/ cross-margin calculations</td><td rowspan="2">Reporting controls and evolution to a stable business as usual process</td></tr>
<tr><td>Regulatory operations</td><td colspan="2">Electronic trading – platform (e.g., SEF) rationalization</td><td></td><td>Segregation and rehypothecation for uncleared OTCs</td><td>CCP default management</td></tr>
</table>

[11] Che Sidanius and Filip Zikes, “OTC Derivatives Reform and Collateral Demand Impact,” Financial Stability Paper No. 18, October 2012.

Margining is another area where better technology and data infrastructure can help. Improving systems capabilities to automatically account for margining differences by CCPs may allow the front office to offer more competitive pricing.

There also is ample room for improvement in the back office, as the level of automation varies widely by product and function: 95 percent of credit confirmation volume is automated at major dealer banks, but automation in commodities stands at only 63 percent.[12] An investment in efficiency will be most important for firms striving to become volume leaders, as any advantage in processing speed and costs per trade will be critical.

Talent management

Investment in operational efficiency and infrastructure alone is not enough to ensure effective execution. Talent is another important factor that demands continuous focus from financial firms. Multiple regulatory guidelines, such as the EU directives on bonuses or the U.S. pressure for disclosure and clawback provisions, are affecting talent compensation. The general trend toward more conservative pay structures — along with cost-cutting pressures — has made paying top talent top dollar increasingly difficult. Balancing executives' expectation for a higher proportion of fixed pay with regulators' preference for long-term performance incentives has proven to be difficult and is largely still a work in progress.

By focusing on non-financial aspects of compensation and talent management, firms may be able to meet specific challenges and manage risk. Leaders could improve the attractiveness of junior roles to lure high-potential new talent, or they could offer additional responsibility to mid-career professionals to deepen the bench of future leaders. A deeper bench would also help mitigate the key-man risk among the firm's high performers.

Talent management and development may be of particular importance for product and market specialists, who base their brand on the availability of deep expertise in more complex or unconventional derivatives products.

Building a regulatory operations function

One potential focus area for operational improvements may be in the creation of a new regulatory operations group or a regulator liaison office to help transactional business lines more efficiently meet regulatory requirements and more visibly manage the complex client and regulatory demands. The concept behind a regulatory operations group is relatively simple: a dedicated team that monitors the production of data, manages the infrastructure of reporting, and acts as an air traffic controller for queries made by internal and external clients, including regulators. Setting up such a group may have some challenges, including acquiring and retaining knowledgeable talent or building the tools needed to access and manage complex data flows, but doing so may also bring substantial benefits as the organization addresses items that might not be in compliance with a given regulation.

Already, several swap dealers are appointing heads of regulatory operations. With a team better able to centralize and manage the regulatory burden and appropriate oversight, firms may be able to create new enablers of effective governance and compliance while allowing revenue generators to continue focusing on business.

[12] "2013 ISDA Operations Benchmarking Survey," International Swaps and Derivatives Association, April 2013.

Moving forward

The OTC derivatives market has undergone a period of extraordinary measures that have permanently changed the dynamics of its market participants (Exhibit 5). Given the number of reforms still underway, the manifestation of many regulatory changes to the businesses of swap dealers is still ahead of us.

Understanding the forces behind these changes is no better than knowing the direction of the wind: useful, but by itself not enough.

Exhibit 5. Drivers and influences on business and operating models

Swap dealers are still assessing how the forces described in Exhibit 5 will affect their business, but key operational, infrastructural, and organizational decisions in support of the business strategy are required immediately.

- Dealers can act as an agency business, supporting trading of highly standardized and liquid derivatives. This is a keenly competitive marketplace and success will likely require capturing more volume and passing on more cost efficiencies to their end-user clients than the competition. Investment on scalable operations and technology cannot wait.
- On the other hand, dealers may rely on the strength of their brand and offer highly tailored products to clients. This is a sparser marketplace, and success requires nurturing clients and offering innovation and deep expertise. This positioning cannot wait long if key clients and talent are to be secured.
- As a hybrid model, dealers can offer a suite of linked derivatives services. Success will be predicated on increasing market share; ease of onboarding and compatibility are two traits that clients need to learn and experience as soon as possible.

Clearly, planning for the new normal does not equal being ready for the new normal. Swap dealers not only need to assess their competitive advantages and select the most viable business model, but must also back up their choices by allocating resources in an efficient operation that facilitates and rewards sustainable market growth.

Business decisions and the adequacy of the operating model will likely impact both the profitability of their business and the return on the invested capital. These are the very same metrics that business leaders focused on before the downturn occurred. However, strategic decisions are arguably more difficult now, given the number of parameters set by parties outside the dealer firms.

In a market that is rapidly evolving, rapid action might make all the difference between sailing easily through the storm and sailing too close to the wind.

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