

The changing FCM business model

THE BUSINESS MODEL FOR FUTURE COMMISSION MERCHANTS (FCMS) IS UNDERGOING RADICAL CHANGE. COST PRESSURES AND REGULATORY BURDENS WITH FRAGMENTING LIQUIDITY AND EVOLVING CLIENT DEMANDS POSE MAJOR CHALLENGES.

FOW AND OBJECT TRADING BROUGHT TOGETHER KEY FIGURES FROM THE GLOBAL LISTED DERIVATIVES MARKET TO DISCUSS THE EVOLVING BUSINESS MODELS FACING FCMS AND HOW THEY ARE TACKLING THE CHALLENGES IN THE MARKET TODAY.

FOUR KEY THEMES EMERGED, ALL INTERLINKED BUT ALL POSING INDIVIDUAL CHALLENGES TO FIRMS. TAKEN TOGETHER, THEY HIGHLIGHT A NEW BUSINESS MODEL FOR FCMS, ONE BUILT AROUND TECHNOLOGY AND DELIVERING EFFICIENT RISK AND CAPITAL MANAGEMENT.



“ FCMs have faced rising costs and lower margins for a decade but have been squeezed more than ever over the past two years by falling volumes ”



RISING COSTS

Rising costs underpin everything FCMs consider when reviewing their business models today. They are waging a battle on numerous fronts with challenges from increased trading fees, technology requirements, costs of compliance and requirements of capital.

Uncertainty over the cost of capital is paramount. New margin requirements for over-the-counter derivatives and significantly higher capital charges for trading have seen many FCMs pull back from the certain services and some exit clearing entirely.

In exchange traded derivatives markets,

clearing was traditionally relatively straightforward in terms of both processes and revenues for the FCM. That is now changing with the return on and cost of capital at the forefront of every FCM business model.

This is creating pressures for FCMs over which clients they clear for and where they clear. The process of on-boarding clients is also becoming more challenging.

With exchanges selling the benefits of their new offerings on margin efficiencies and segregated accounts mandated by European regulators, FCMs need to ensure they can meet expectations and requirements.

FCMs have sometimes been reluctant to sell products to clients that result in higher

costs and complexity. But today they have no alternative due to new mandates and more communication between exchanges and clients.

Internally, FCMs are restructuring with clearing at the centre of their service. Collateral management tools, which might once have sat within niche or targeted product lines, are now at the heart of the modern business model that brings futures, clearing and collateral together into one service.

FCMs have faced rising costs and lower margins for a decade but have been squeezed more than ever over the past two years by falling volumes.

As exchanges grapple with lower volumes, some are seeking to hike fees on auxiliary services such as market data.

But FCMs complain this is counterproductive and means higher costs, lower margins and lower volumes, which is bad for everyone.

Exchanges insist they invest this revenue in services to make their users more efficient. But many FCMs feel unable to pass on cost to their clients, exacerbating their cost pressures.

Others however, have restructured how they present costs to clients to help them understand what is being charged and where.

One FCM said his firm had moved from offering one price for the total service to a breakdown of clearing fees, execution fees and commissions so the client can see costs.

This has helped clients understand where the FCM is charging and what is a standard cost they would face elsewhere, an approach that may become the standard model for firms in the future.



RISING COMPLEXITY

Reforms to force over-the-counter contracts onto electronic platforms and clearing are changing the business models of FCMs but also for exchanges, which has implications for FCMs.

A new age of competition is dawning across Europe as exchanges seek to capitalise on the changing market. In the new world, decisions on where to execute will be made based on where firms want to clear, providing trading venues with the opportunity to wrest liquidity from incumbents on a scale not seen since the

advent of electronic trading.

While the market broadly welcomes competition, increased complexity is inevitable, as is the fact many new products and venues will ultimately fail.

The launch of Swap Execution Facilities in the US and upcoming launch of Organised Trading Facilities in Europe increases this complexity.

One panellist said maybe only nine of the Sefs that had launched would attract material liquidity in the long term. But the challenge for ISVs and brokers is choosing which to use before it is clear who will survive.

One challenge for Sef operators has been how to link to FCMs. For many Sefs, this is a new relationship and comes in addition to building out to CCPs and trade repositories.

Ultimately the market will move towards a smaller number of Sefs connected directly to numerous FCMs but it will take time and lost investment to get there.

Almost a year after the introduction of Sefs, the market has not significantly changed with incumbents still strong in their relative fields.

The need for margin efficiency across venues and asset classes becomes greater with increased fragmentation. FCMs are expected to offer services that incorporate new contracts and venues.

To do this with efficient use of margins, FCMs need transparency from clearing houses about how they build their risk models and calculate margins.

One FCM said third parties will be able to develop calculators that run as industry utilities enabling FCMs to calculate margin requirements across CCPs.



CHANGING ATTITUDES TO TECHNOLOGY

Increased complexity and cost is changing attitudes to technology.

FCMs were reluctant to outsource technology as it was seen as a risk taken to reduce costs.

But outsourcing today is increasingly common as the cost and complexity of inhouse technology rises while vendor systems improve.

Specialist providers are taking a more collaborative approach with their clients,

“The more technology we can outsource, the better. We just have to work to ensure the outsourced technology interfaces with our other technology.”

working more as a partner than a provider.

But outsourcing also provides challenges and complexity. One FCM that chose to work with a number of vendors said decisions were taken based on existing client loyalties.

Attitudes to technology outsourcing are changing too as services become commoditised. Market connectivity has become a commodity, said one FCM, whereas firms had no choice but to build in-house ten years ago.

Hosting has resulted in lighter operational requirements for FCMs.

No longer are they required to run teams focused on maintaining and upgrading connectivity. The vendors have taken on much of that work, reducing the cost for FCMs.

“The more technology we can outsource, the better,” said one FCM. “We just have to work to ensure the outsourced technology interfaces with our other technology.”

He added that as clients demand more asset class coverage and a one-stop service from their FCM, outsourced technology is increasingly the enabler.

ISVs are then able to draw on the collective requirements of clients to develop new products and services, mutualising the cost of that development.

The introduction of Sefs in the US is an example of how an outsourced collaborative approach to technology can solve a complex problem.

CFTC rule 1.73 mandated pre-trade

clearing certainty when trading on Sefs, creating a huge technology challenge.

Rather than every FCM running their own projects, external vendors created credit hubs that spread the cost and created a common platform for pre-trade risk.

Delegates said recent advances in technology allow them to try new markets and products far more simply than before.

“We don’t want to be left behind, so it’s a case of wanting it as soon as you possibly can, as cheap as you possibly can, and built in with your own infrastructure you’ve got,” one said.

The days of FCMs locking in a client by providing a platform are long gone.

FCMs are having to adapt to client demands for trading new venues or products more quickly than before, which means understanding the business case and making a conscious decision over how they will get that ROI happens in a shorter timeframe.

Clients are becoming empowered. Exchanges now promote initiatives directly to clients rather than the FCM. Proprietary trading firms in particular strive to be early adopters of markets and products and are increasingly important in terms of the support they provide.



LINKING PRE- AND POST-TRADE

Some FCMs at the forum had only recently entered the market and had therefore the chance to build technology from scratch without the legacy technology prevalent at older firms.

Linking the front and back-office workflows is seen by FCMs as the key technology challenge in today’s trading environment.

Traditionally firms have taken post-trade data feeds without reconciling those with the pre-trade lines and have, therefore, been limited in terms of the transparency of the trade cycle.

One FCM, which recently re-launched its futures operations, said it had mapped the entire end-to-end data model from front to back as a starting point.

They looked at risk and surveillance as two key areas of importance, anticipating the upcoming regulatory reform and asked how to build a system that gave transparency of risk in real time and across the trading architecture.

“ More efficient communication between pre- and post-trade systems will become more prominent with the implementation of Mifid II ”

Avoiding duplication of processes was another key factor as was the need to automate mapping across all processes to ensure that one missed entry didn’t render the risk picture irrelevant and straight-through-processing from execution to settlement.

Another FCM went through the same process but from a different angle: beginning with settlement and working through to execution and pre-trade risk.

Clients increasingly want intra-day views of pre- and post-trade risk as well as capital and margin allocation. FCMs will offer multiple ISVs to clients and this creates added complexity from a holistic risk perspective.

The average FCM will have clients using different ISVs across different asset classes and this causes a challenge when managing intraday positions and feeding data through to a central risk system.

To counter this, one FCM said firms should focus on minimising the complexity of front end risk controls and stick to basic pre-execution rules.

But for more complex clients, pre-trade risk is no panacea. Options market-makers send thousands of orders into a market with little inherent risk. This requires a different way of thinking, with the onus falling on the back office rather than the front.

More efficient communication between pre- and post-trade systems will become more prominent with the implementation of Mifid II.

Esma’s paper refers to linking pre- and post-trade risk systems to achieve a real

time credit view of your counterparty risk for specific clients.

But different FCMs understand and calculate risk in a different ways. Defining what constitutes a single counterparty is also unclear.

In the US, the Legal Entity Identifier system overcomes this but there is no equivalent in Europe. Different margin segregation regimes in the US and Europe add to the confusion.

One FCM said more could be done to improve circularity between pre- and post-trade risk. They said the industry should be working towards a global view of positions across all markets.

Some FCMs said risk controls were being used as selling points by FCMs to retain clients, a practice that could be countered by the industry agreeing a minimum exchange level control.

But others said risk controls should lie firmly in the hands of the FCM, assuming pre and post trade risk controls are in place.

Risk levels vary from client to client and larger, multi-billion dollar clients would not require real-time post-trade analytics.

But once limits are in place, they need to be conveyed to each client in a way that enables the FCM to manage client limits while showing those clients how those limits are calculated.

FCMs therefore must understand in real time its counterparty exposure across every single execution channel. So, on the post trade portal, the client can see exactly what their limits are and what their usage is in terms of their credit with their FCM across listed and OTC.

Once understood that has to be fed back into the pre-trade controls, closing the loop.

Ultimately, firms need to see real time risk to make intelligent decisions around how to manage those pre trade risk limits, whether they are with an exchange or in various ISV platforms in real time.

This is where real innovation will come from in the next few years.

To solve the challenge of CFTC rule 1.73, market participants in the US got together and asked vendors to come up with a solution. As technology becomes commoditised and the market becomes more complex, the imperative to understand risk in a commoditised format grows. 