white paper

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The Winner Takes It All?

How banks will cope with regulation on OTC derivatives

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Tags

OTC Derivatives – regulation – EMIR – Dodd-Frank-Act – survey – investment banking – central counterpart – clearing – market opinion – market concentration - transparency

Summary

The 2013 Firstwaters survey among Europe's leading banks shows that the ongoing regulation of the OTC derivatives market (triggered by EMIR and Dodd-Frank) will probably lead to a further standardisation of the business. The division between US and European markets will likely increase, and customers are expected to rush to the big players. The top-tier banks will be best suited to meet the expected effects of cost pressure and shrinking margins. They will benefit from the regulatory challenge and most likely win market shares. For the next years, banks expect a consolidation in the overall market with simpler products and a continuing pressure on pricing and transparency.

Recent times have brought substantial changes for all participants in the derivatives industry. Regulators in all developed markets have set new frameworks, like for instance EMIR in the EU and the Dodd-Frank-Act in the US. The new regulation requirements will change the rules of the game fundamentally.

While everybody in the banking industry are doing their best to meet the moving targets set by the regulating authorities, the outcomes for the industry and its players remain somewhat unclear. We want to make a first step to shed some light on the questions how banks will cope with the challenges presented by the new regulation sets and give a first idea on what the landscape of derivative trading might look like once the dust will have settled.

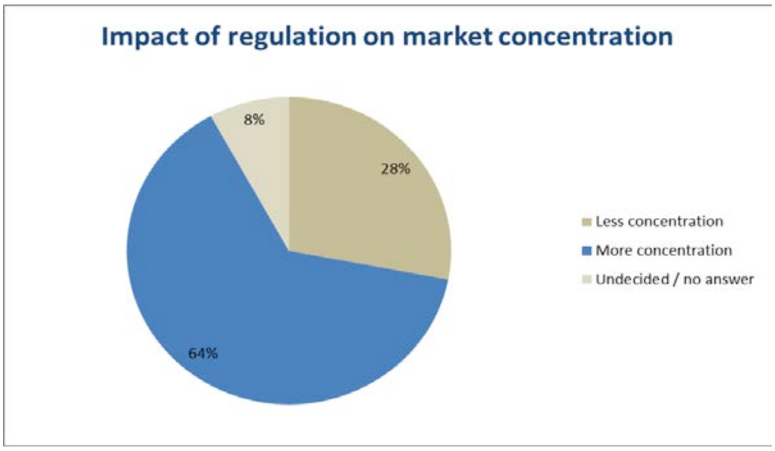
Survey setup

For that purpose we have conducted a survey among Europe's leading banks. We invited the top 120 European banks measured by market capitalisation and balance sheet figures. We sent a weblink to participants inviting them to answer the questions presented in an online questionnaire with tick boxes and open text fields for comments on our questions. The response quote remained slightly above 20% with a responding sample of 25 responding banks. Simple descriptive statistical statements should be thus valid. As the survey was anonymous, we cannot determine any biasing effects between responding and non-responding banks.

The regulators have set new requirements that lead to more standardisation and make life potentially harder for niche players. Large players should be best suited to fit into factory-like derivative trading, and they may also be able to enjoy the benefits of degression that come with fixed costs (like onboarding a Central Counterpart (CCP), set up new IT systems etc.) Entry barriers for new market participants may also have deterrent effect on potential new players.

Impacts of regulation on derivatives business

We would therefore expect that market concentration should increase with the implementation of the regulatory framework. Almost two-thirds of the responding banks have shared that opinion – they expect that market concentration will increase. The large sell-side banks offering derivatives to their institutional and corporate customers may be benefitting from this concentration effect: 56% of the responses suggest more business in the wake of the regulation changes, most of it coming from newly attracted clients. Comment fields specified that market participant expect a rush to the big players: Tier 1 institutions will probably enjoy more business, while small-scale banks will have to struggle.



1 Regulation will lead to more market concentration

The predicted trend to a commodification of the derivatives industry is also mirrored in expectation on product features: Most respondents (70%) predict that derivatives will be more simple in the future and that exotic products will get out of focus.

Another hypothesis that we wanted participants to affirm (or reject) is that the regulation may lead to geographically separated markets. We have seen on our consulting projects several market participants who did not want to become subject to any foreign regulatory jurisdiction: US banks tried to avoid having to handle with EMIR implementation, and EU banks that tried not to rise above any of the Dodd-Frank thresholds. As the authorities have been slow to present final cross-border rules, we wanted to know if this observation could be part of a larger trend. In fact, only 12% of our respondents expect that cross-regional trades will increase, while almost 70% expect less cross-regional business. Comments from the banks suggested that there may be differences between the regions in question. So it might be possible that two regions with well-orchestrated frameworks will see increased trading, while non-corresponding regulatory sets may lift walls between regions.

Looking at asset classes, the question is how well they fit into the new landscape and if the market participants will be doing business despite increased standards and the following transaction costs. When asked about the future prospects of asset classes, the respondents were most optimistic about increasing volumes for Credit Derivatives and FX related trades. Equity Derivatives and Exotic / Hybrid products find less support among the responding banks. The opinions about Interest Rate Derivatives are clearly divided; nearly half of the sample indicated substantial growth, while in contrast 40% predict decreasing volumes.

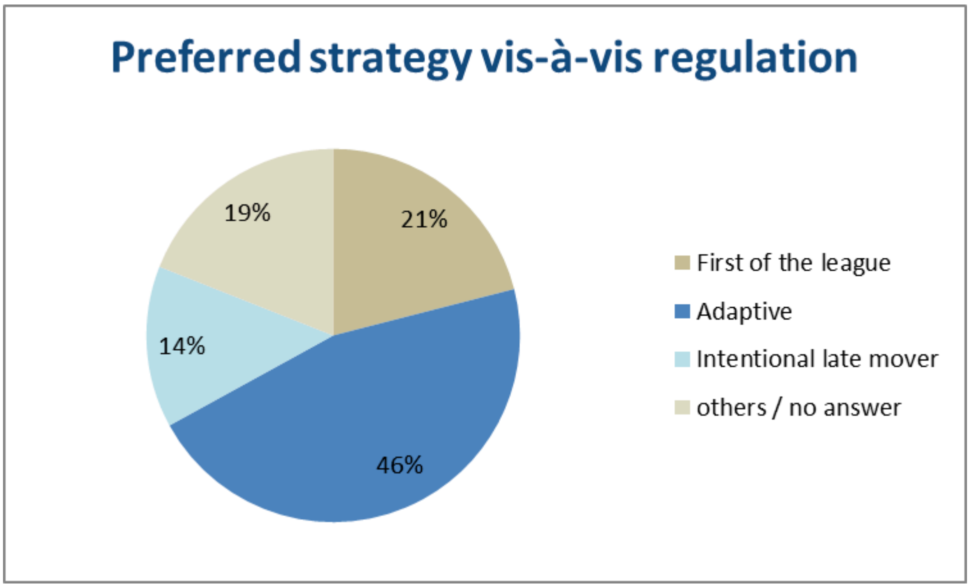
When asked about the impacts of regulation on profit drivers, the responses gave a fairly clear picture: Respondents expect overall trade volumes and product margins to go down, while all cost types (processing, funding, and capital costs) are expected to rise with funding costs for collaterals, margins and default fund contributions leading the field.

Strategic picture

Like all externally induced changes, the new regulatory framework for derivatives can be both challenge and opportunity. The market concentration and the trend for standardised factory production may be seen as a chance – particularly for bigger players – to assume a proactive role in implementation. While the big fish could look for a business case, smaller players could be more reluctant to adopt the regulation.

There are some points where technical specifications are still unclear and supervisory authorities' expectations and consequences will only become obvious when authorities come to their first findings with the first movers. Thus, first movers face higher risks and may incur costs that later adopters can avoid.

Amongst our sample, most banks (46%) seek an adaptive strategy of being among the middle group of peers to implement, after more detailed and precise recommendation has been issued by the regulator. In contrast a minority of 21% of participants try to be first of the league and exploit economic benefits from implementing new processes and features in derivative business.



2 Most respondents prefer to adapt

So it seems that some banks try to take the driver's seat while others remain more cautious; the role of last minute catcher (only do what is required and as late as possible) was least popular among respondents (14% of our sample).

Comment fields supported the view that the reaction will depend on the resources of the banks: Respondents wrote that only the largest banks will be able to pursue a "First of the League" strategy, while all others just struggle to keep up with the crowd.

Implementation priorities

The new derivatives regulation comes along with several other change drivers that compete for resources in the bank. We asked for the perception of importance of change drivers.

For back and middle offices, EMIR and Dodd-Frank seem to have highest priority for implementation projects, along with the corresponding requirements of local regulators and the introduction of additional services following customer demand.

For the front office, the key drivers are customer services and P&L optimisation. In the second row of drivers, we find market competition and the derivative regulation.

Thus it appears that the regulation is mainly an issue for middle and back office units. Another finding is that the requirements around Basel 3 appear to be thrust into the background; we offered that driver, too, but it received little attention.

What will follow?

Finally we wanted to assess the respondents' opinion on the next steps once the EMIR / Dodd-Frank changes will have been digested by the banking industry. What will be the next big thing in banking?

For banks like their own most respondents expect that additional customer services will be of top priority. Along come the issues "transparency of costs and pricing" and "efficiency of Front / Middle / Back Offices". In contrast, all questions around generating revenues from derivatives, creating new products and attracting new clients are kept at lower levels of attention.

This leads to the conclusion that we might expect years of consolidation and internal improvements rather than bullish times of market expansion in times to come.

For the industry as a whole most respondents predict higher degrees of transparency in portfolio valuation, costs and pricing. Moreover, competition among financial services is expected to increase. Revenues and trades volume, on the other hand, are more likely to decline in our respondents' view.

Conclusion

The market for OTC derivatives seems to follow on the journey to standardisation and price-oriented competition that other banking products have already made. OTC derivatives will become more commodity-like than they used to be: Banks will offer simpler products, standardised processing, and a high level of transparency in prices and procedures. In a setting like this, where distinction by product features will be replaced by straightforward price-oriented competition, only the players with deep pockets will be able to afford to make the necessary investments in IT, processes and infrastructure to keep volumes high and remain at the top of the race.

About the authors

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About Firstwaters

Firstwaters are an independent consulting firm, providing consulting services to the financial services industry. With offices in Aschaffenburg and Munich, Firstwaters act as „engineering firm" for banking corporations, specialised in linking business strategy and processes with technology by implementing ready-to-use tailor-made software solutions. Firstwaters were founded in 2000, by 2013 Firstwaters had 40 employees.

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