acuiti management intelligence

The Derivatives Insight Report

April 2020

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Introduction

In this time of uncertainty, one thing is for sure - no one in the derivatives industry will forget March 2020. But it is a sign of the times that after the strongest month ever for both volumes and revenues, we find ourselves wishing this will come to an end.

To date, the derivatives market has proved its value during this time of immense turbulence. Firms across the world have largely overcome the unprecedented challenges posed by record breaking volumes during the largest global operational shift in the move to remote working.

Our report this month points to the success of the market in managing the abrupt shift of risk across the globe. We find that, while they have been issues as one would expect from a scenario few disaster recovery plans envisaged, operations have held up and firms have functioned.

The frailties of many back office operations have, however, been exposed. When the time for reflection and introspection comes, back office technology should take centre stage.

For now we remain in the thick of it. The big concern we hear across the market is what will come next. A recession is inevitable, a financial crisis possible and a return to central bank support of the economy and the ongoing challenge of low interest rates all but certain.

Now though is the time for continued focus on the safety of staff and operations.

SECTION ONE:

Responding to the Coronavirus

Unprecedented operational challenges as virus spreads

The sudden and unexpected spread of the coronavirus caused unprecedented volatility across the world's markets, presenting major operational challenges.

For firms involved in trading, clearing and market operations, the outbreak of volatility and huge volumes came at a time of immense operational disruption as lockdowns triggered disaster recovery plans and extensive working from home arrangements.

In order to better understand the pressure that the spread of the coronavirus has placed on operations across the derivatives market, we surveyed members of our network between 2 and 11 April on their experiences, concerns and reactions to the ongoing crisis.

A major challenge for operations heads has been the shift to working from home. Most disaster recovery plans envisaged a move to a remote location rather than a shift to an entirely decentralised way of working with almost all staff working from home.

Despite this, we found that a majority of respondents reported no issues or small issues that were easily rectified.

For sellside firms that experienced issues, communications with clients was the biggest problem with 23% of respondents citing this as a major challenge. Communications with colleagues was also an issue for 16% of respondents.

Major challenges that impacted serious operational workflows such as what can be traded or offered to clients and risk management were less significant for the sellside with just 12% and 9% of respondents reporting problems.

For the buyside and proprietary trading firms the move to working from home reduced the capacity of what could be traded for 21% of respondents while issues communicating with providers was a problem for 17% of firms.

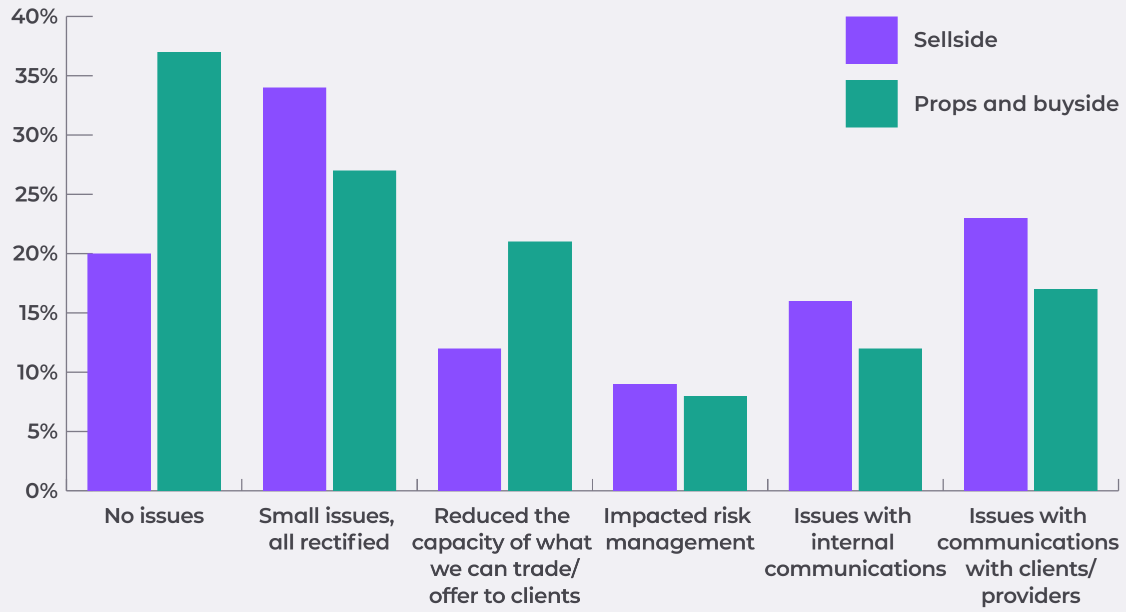


Fig 1. What issues has working from home presented your business? (% of respondents selecting option, multiple selection allowed)?

Back office buckles under weight of all-time volume highs

The high volatility and increased volumes had a major impact on operations across the market. As volatility spiked, average daily volume on major derivatives markets more than doubled in many contracts putting huge pressure on traders' and clearing providers' systems.

We found that the biggest issues were seen in back office processing with 29% of props and buyside firms and 58% of sellside firms reporting major issues in the back office.

Risk management systems also came under strain with 18% of props and the buyside and 13% of the sellside reporting major issues while the process of managing give-ups also experienced difficulties with 15% of sellside firms reporting major challenges.

Front office software was, by contrast, remarkably robust with no prop or buyside respondents and just 3% of sellside respondents reporting major issues.

Has the increased volatility and volume caused any major issues with the following processes or operations?
(% of respondents selecting option, multiple selection allowed)?

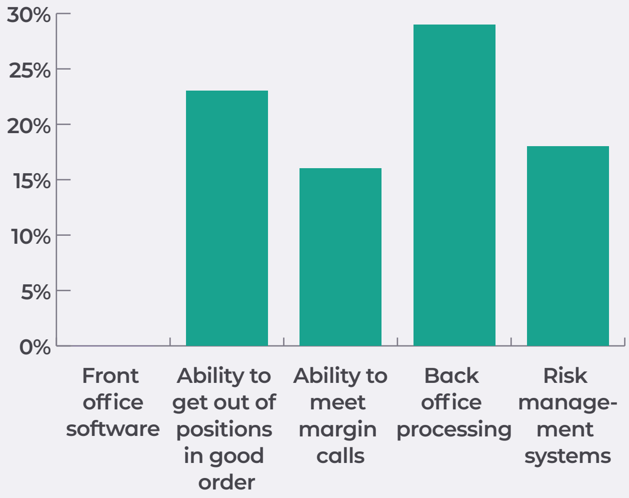


Fig 2. Props & buyside

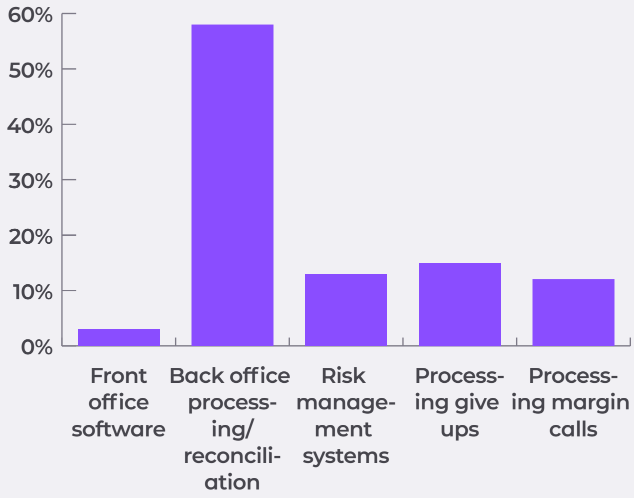


Fig 3. Sellside

Reducing risk limits

One of the most significant reactions to the volatility has been a widespread move by banks, non-bank FCMs and brokers to cut back on risk limits and leverage offered to clients.

We found that 60% of banks, 78% of brokers and 90% of non-bank FCM respondents had reduced limits with 10%, 25% and 10% respectively cutting limits to all clients.

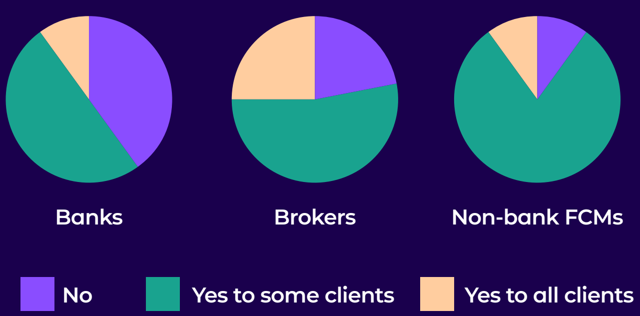


Fig 4. Have you reduced risk limits/leverage to clients?

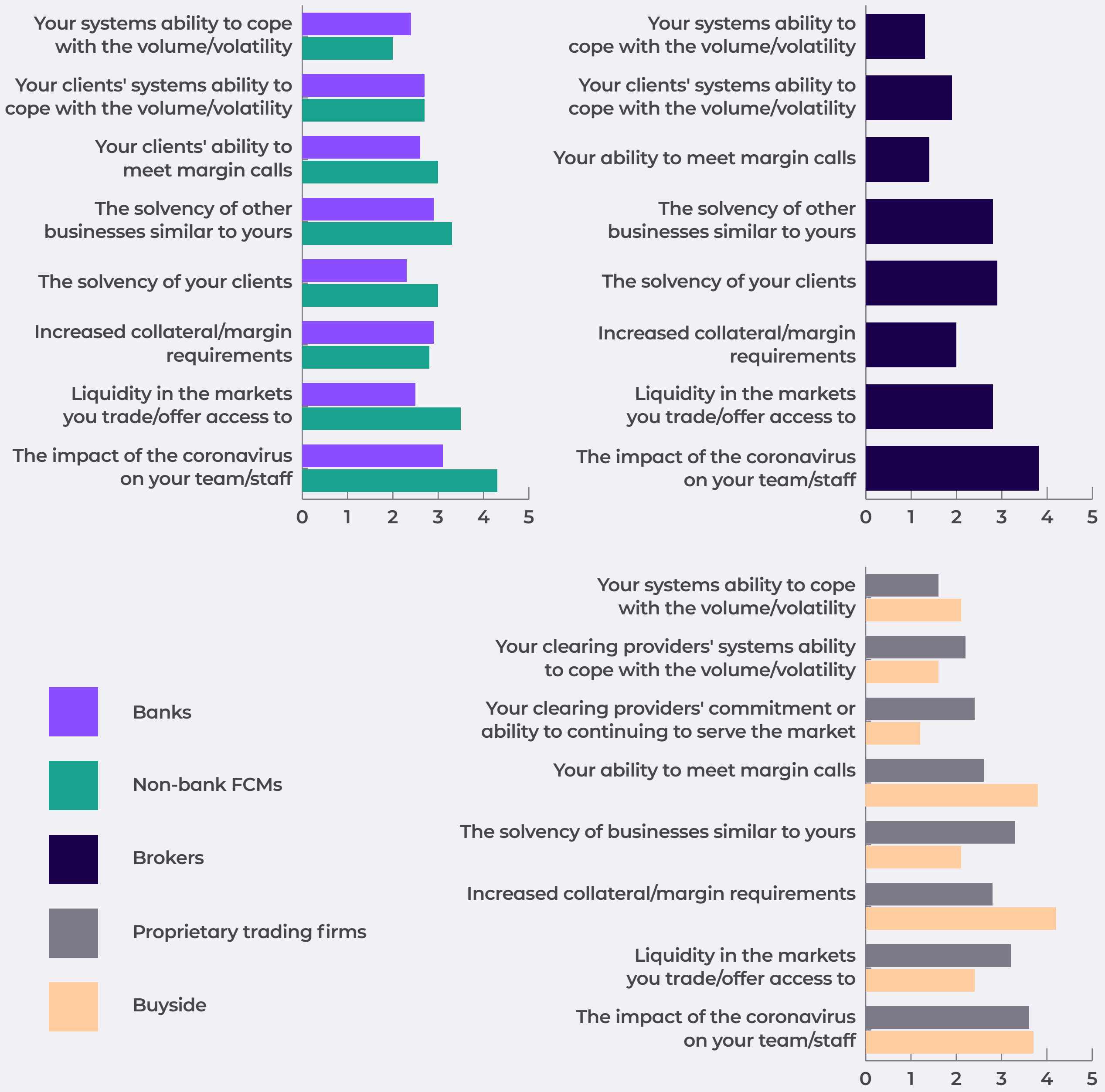
Concerns over liquidity and margin calls

We asked respondents to rate their levels of concern from 1 to 5 across a range of metrics. We found that for all respondents the impact of the coronavirus on staff was the major concern.

For banks and non-bank FCMs, client's ability to meet margin calls was also a major issue, which was also reflected in fears over the solvency of clients. In addition, brokers were concerned over the solvency of clients and liquidity, a concern shared by non-bank FCMs.

For proprietary trading firms, the major concern was the solvency of other prop groups as well as liquidity in the markets they traded. Buyside firms were most concerned by increased margin requirements.

Fig 5. In light of the ongoing crisis, how concerned are you about the following (average response out of 5):



Looking forward

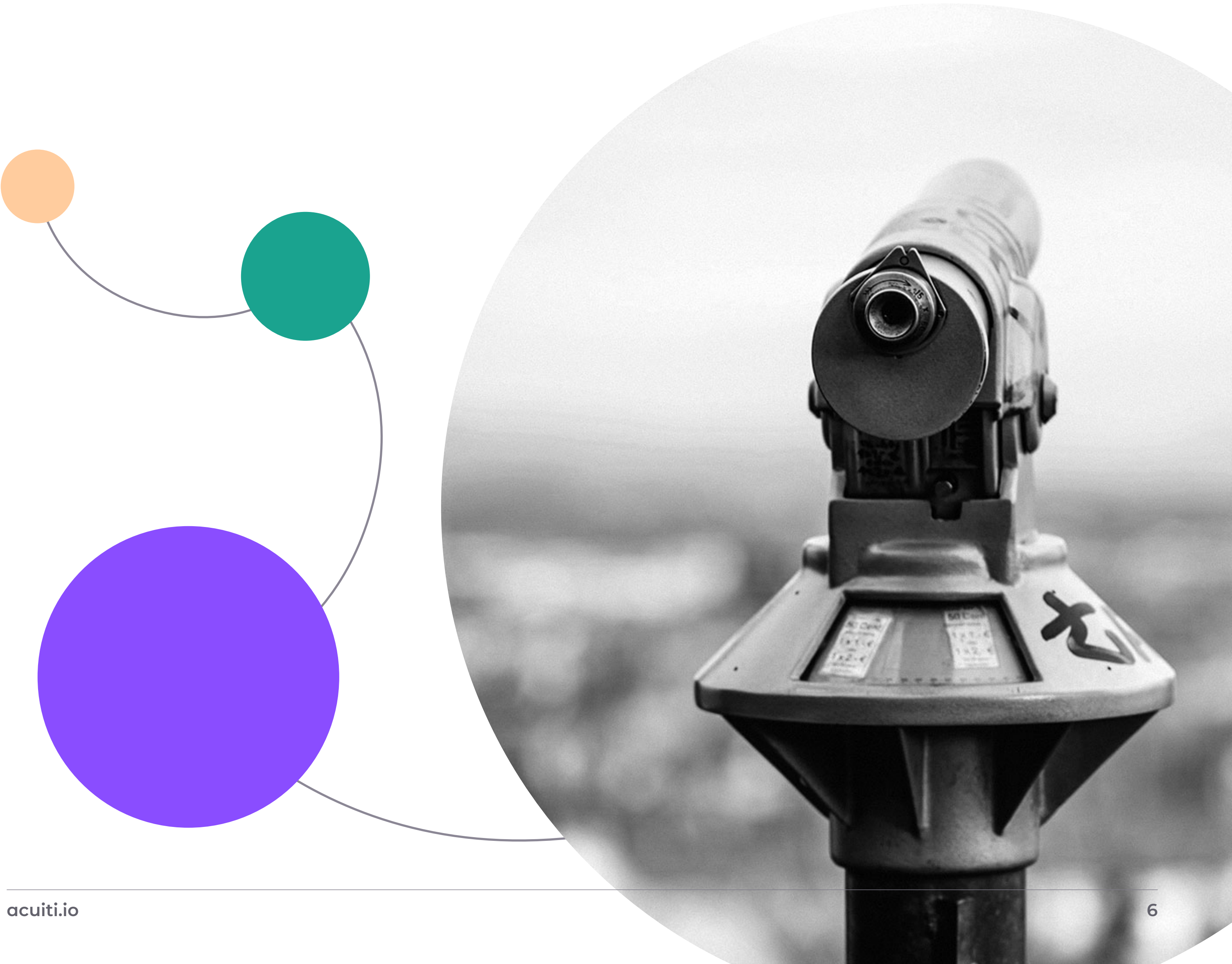
Unsurprisingly the major concerns raised about the medium to long term impact of the virus were the impact on the global economy and lasting damage to employment levels stemming from the economic lockdown implemented to reduce the virus's spread.

Fears were expressed across the market about a reduction in volatility and liquidity as the crisis evolves. One respondent said they were concerned that "*we will go from one extreme of volatility to the other – no liquidity and no volatility at all*".

Reduced liquidity was a major concern across the board as markets returned to an environment of central bank support and a widespread "risk-off" reaction from market participants.

For banks and non-bank FCMs, the steep cuts in interest rates implemented by central banks are expected to reduce revenues from client funds in the medium to long term.

Numerous participants warned about the risks of closing markets with one making the point that a shift in mark-to-market valuations upon reopen "*might be too much for the system to bear*".



SECTION TWO:

Revenues

Revenues continue to sky-rocket as volatility persists

For the second consecutive month, the Acuiti Derivatives Insight survey found significant revenue growth across the globe as unprecedented volatility gripped global markets.

What was most notable about this month's revenue pattern was its binary nature with just a handful of respondents reporting similar revenues to the previous month and the majority of the rest either significantly up or, in some isolated instances, significantly down.

As volume records were smashed at exchange after exchange, the derivatives market continued to function providing liquidity and risk management to firms across the world.

However, there are signs of strain in the system as more firms reported significant losses than last month with the number of such firms doubling to 10% this month.

There was no pattern to the losses with small numbers of respondents across all company types reporting losses. The brightest spot last month was the non-bank FCMs, all of which reported higher revenues last month with almost 80% reporting significantly higher revenues as one would expect from a transactional business.

We found that some trading desks at banks experienced losses as did several brokers, the latter owing to operational challenges associated with the move to home working.

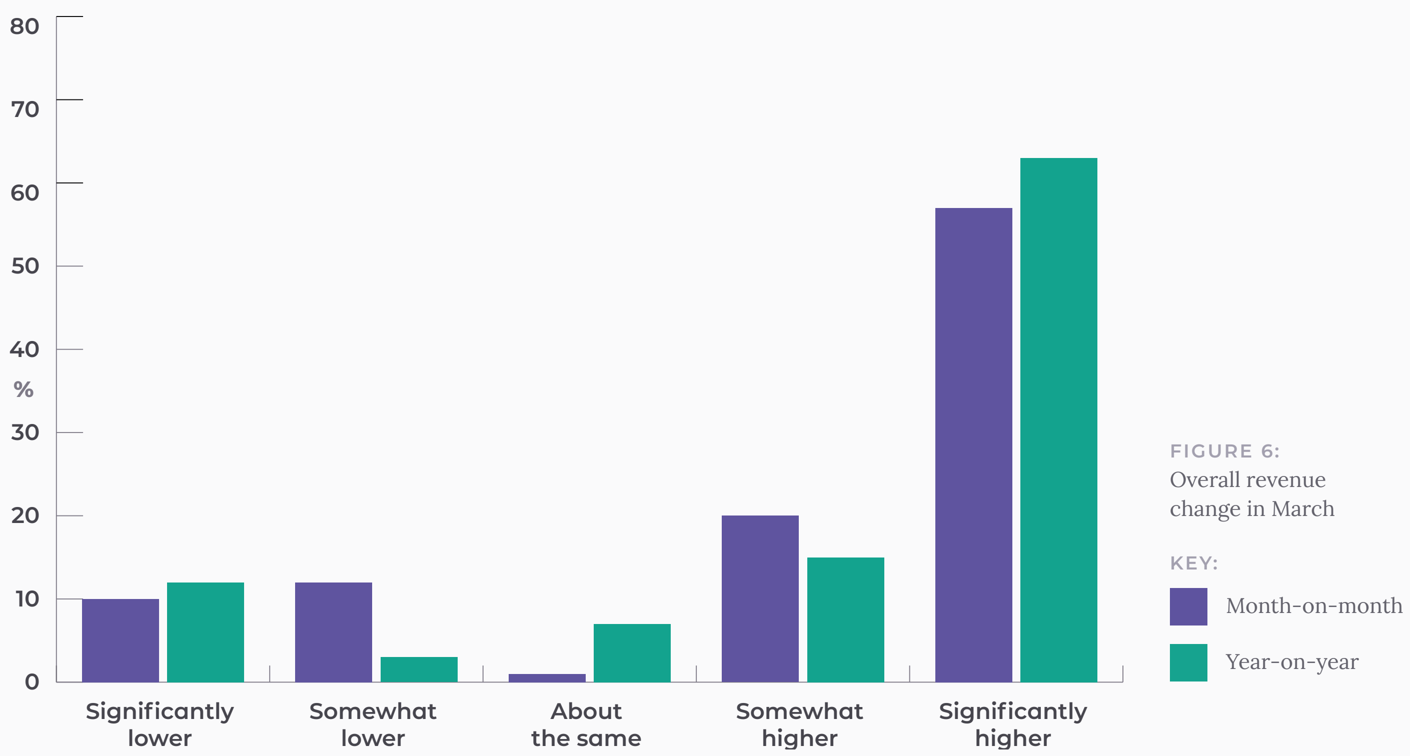
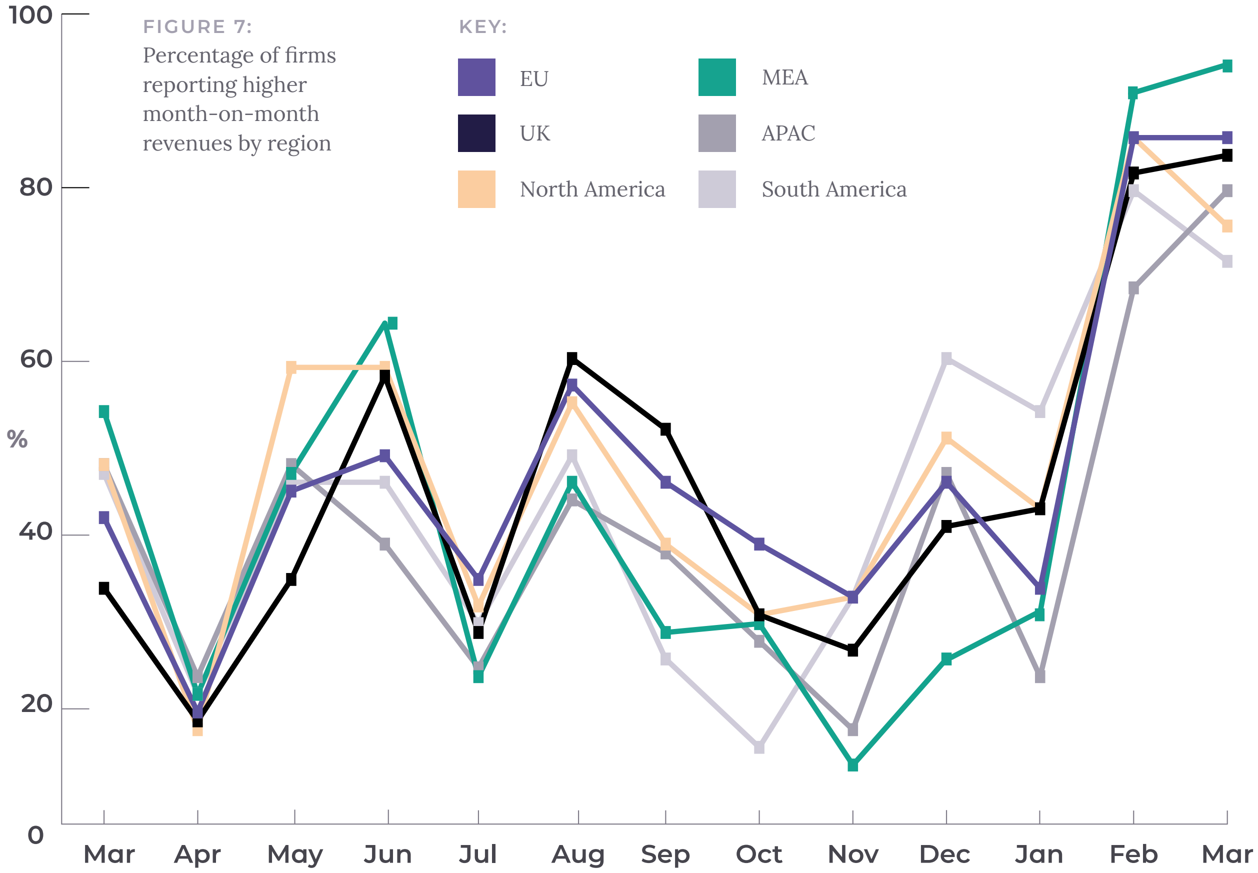
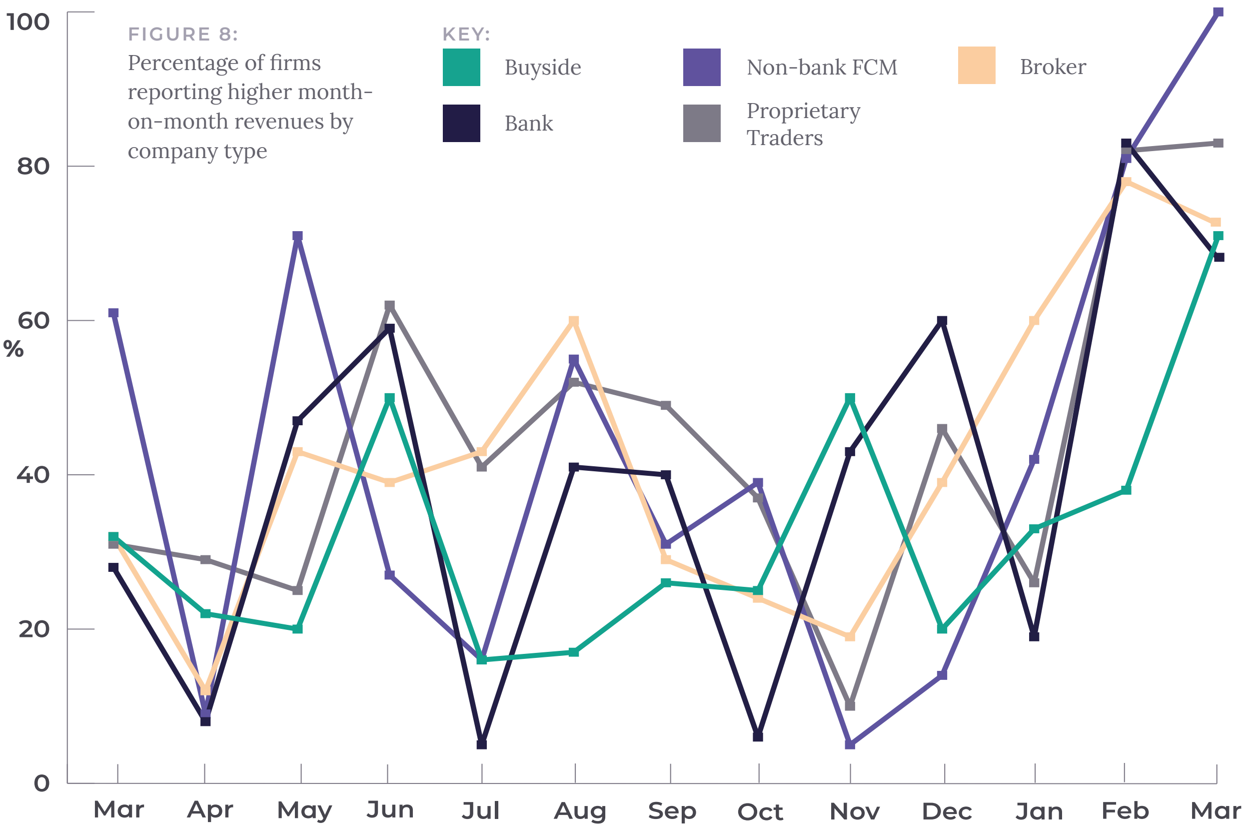


FIGURE 6: Overall revenue change in March

Historical revenue growth





Revenue change by company type

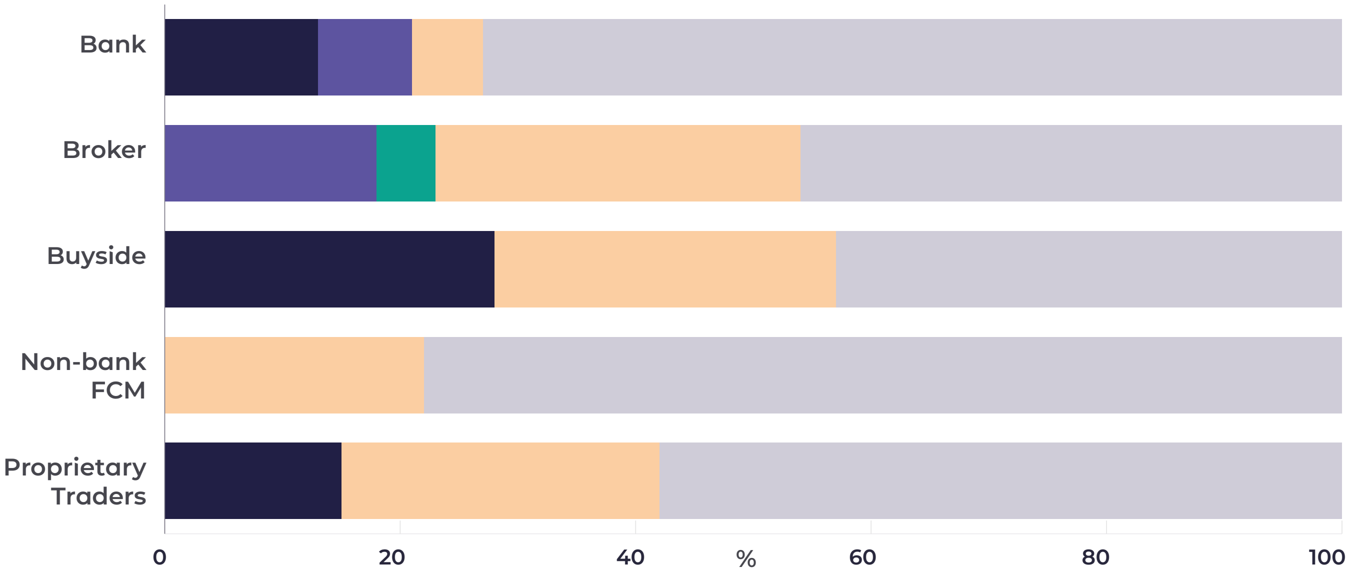


FIGURE 10:
Month-on-month revenue change by company type

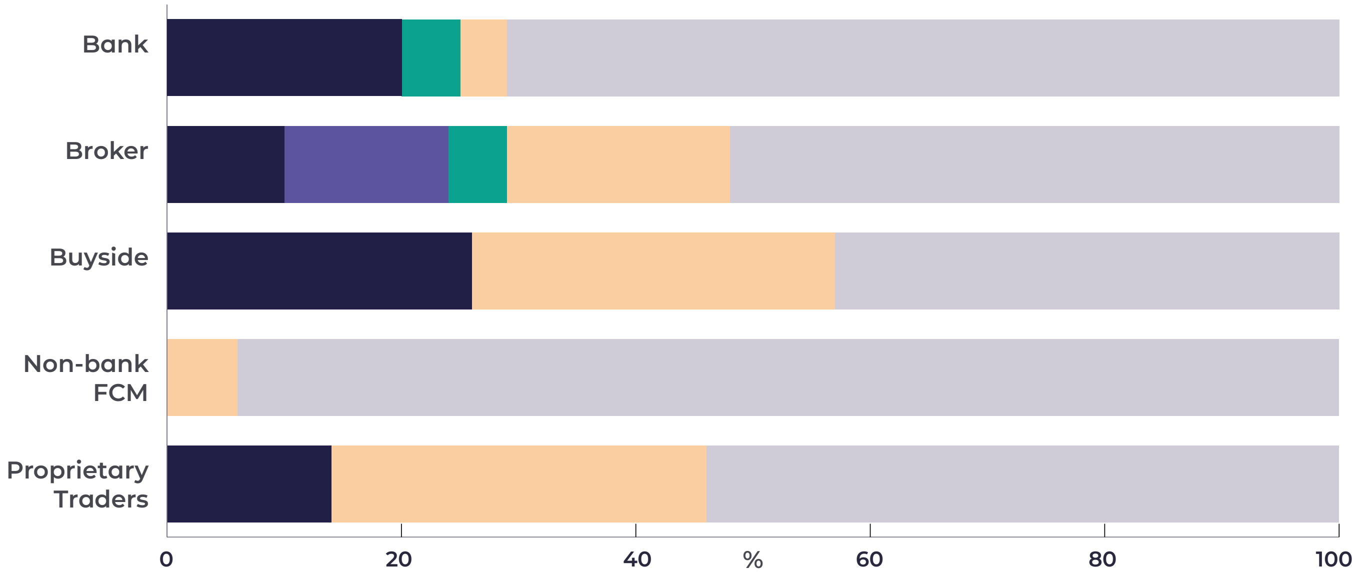


FIGURE 11:
Year-on-year revenue change by company type

KEY:
Significantly higher
About the same
Significantly lower
Somewhat higher
Somewhat lower

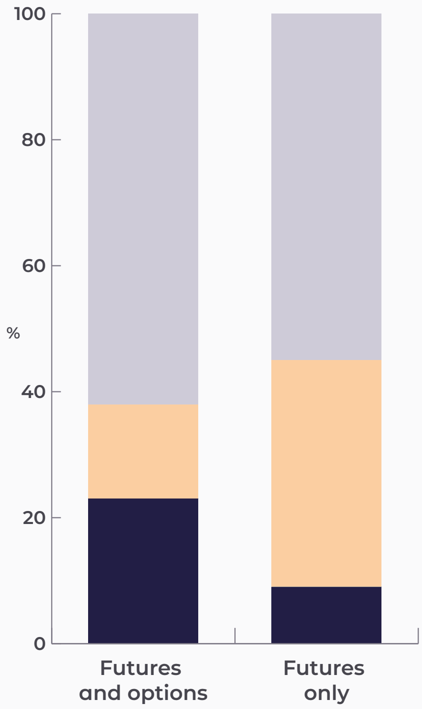
Revenues rise across all company types but some pain evident

For the second consecutive month, revenues rose sharply across all company types, however, there is growing evidence of the stress that the current market conditions are causing across the market.

Non-bank FCMs posted the strongest performance with 94% reporting significantly higher year-on-year revenues and all respondents reporting increases month-on-month.

In line with their non-bank peers, clearing departments at banks almost universally reported higher revenues, although there were limited reports of heavy losses. Trading desks at banks had a more challenging month with several reporting falls in revenues last month - with most of those citing operational issues that impacted the ability to trade. However, these were the minority with most desks reporting strong returns.

As with last month, proprietary trading firms tended to perform very well during the volatility. The performance was binary, however, with no firms reporting similar revenues to the previous month and some firms reporting significant losses. These firms tended to be trading options although there were some significant losses related to futures trading.



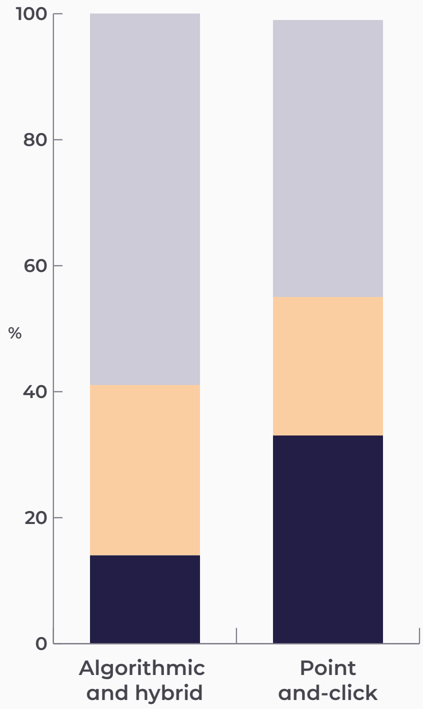
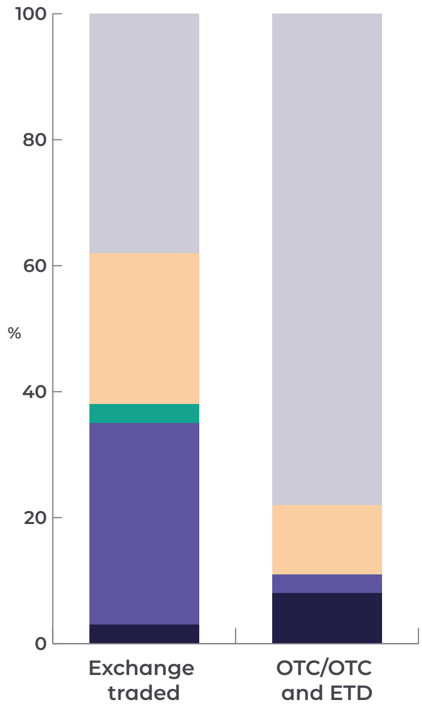
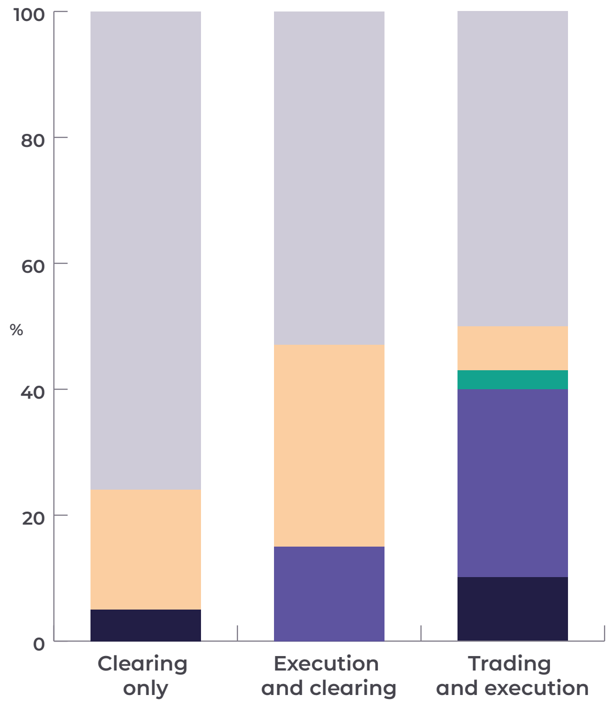


FIGURE 12 & 13:
Proprietary trading revenues by contract type and execution method (month-on-month)

FIGURE 14 & 15:
Sellside revenues by service and instrument type (month-on-month)

KEY:
- Significantly higher
- Somewhat higher
- About the same
- Somewhat lower
- Significantly lower





Revenue by region

Overall month-on-month revenue rise:
81%

Top performing company type (month-on-month):
Proprietary trading firms

Best asset class:
Equities and equity indices

EU

Over 80% of respondents from the EU reported higher revenues for the second consecutive month with proprietary trading firms having a particularly strong month.

All proprietary trading respondents reported higher month-on-month and year-on-year revenues with 79% reporting significantly higher revenues.

Similarly all non-bank FCMs reported higher revenues with all reporting significantly higher year-on-year revenues.

Banks tended to report significantly higher revenues for both month-on-month and year-on-year. However, disruption to operations and volatility resulted in some losses being reported by a small number of trading desks.

Buyside performance was more nuanced with around 18% reporting significantly lower revenues.

Equity index contract volume surged in March with Eurex's suite of index products up 91% year-on-year to 193m contracts traded. Euronext also experienced heavy trading across the board with single stock futures up more than 300% year-on-year, index futures up 92% and commodity futures and options up 87%.

KEY FINDINGS

- All prop trading respondents reported increases for 2nd month
- Sellside generally up sharply but some losses reported
- Contract volumes soar across all asset classes at Euronext

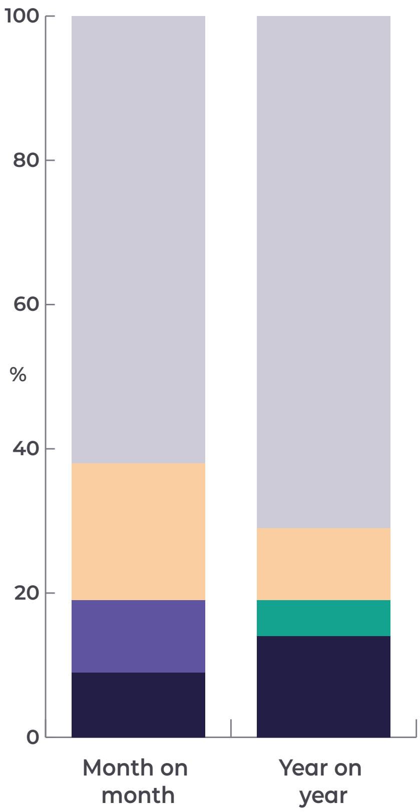


FIGURE 16:
Revenue performance in EU

KEY:

- Significantly higher
- Somewhat higher
- About the same
- Somewhat lower
- Significantly lower

United Kingdom

For the sellside, performance in the UK followed a similar pattern to that across the rest of Europe with a very strong non-bank FCM performance mirrored by that of clearing operations at banks.

As with the EU, there was evidence of stress at some sellside trading operations and at some hedge funds.

While the vast majority of proprietary trading firms reported a very strong performance both month-on-month and year-on-year, 8% of proprietary trading respondents from the UK reported significantly lower revenues.

ICE Futures Europe broke volume records across the board last month with Brent futures hitting 32.8m contracts and smashing the record of 23.7m set the previous month. Brent options volumes soared to 4.7m contracts from 3.2m in February.

Interest rates also hit record volumes with 57.3m interest rate futures changing hands exceeding the record 45.7m set in March last year. Interest rate options were also up to 17m contracts from 9.1m the previous month.

Equity derivatives were up sharply to 11.6m contracts from 4.4m in February and 2.6m in January.

KEY FINDINGS

- **Non-bank FCM revenues soar in the UK**
- **Some pain for props as 8% report significant revenue falls**
- **ICE Futures Europe smashes energy and rates records**

Overall month-on-month revenue rise:
79%

Top performing company type (month-on-month):
Non-bank FCMs

Best asset class:
Energy

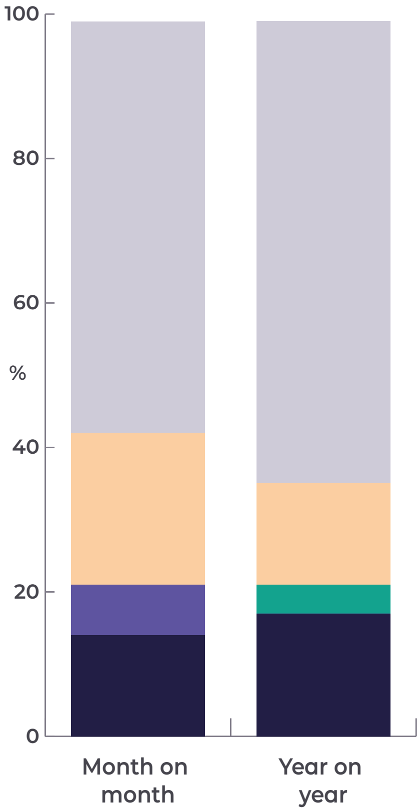


FIGURE 17:
Revenue performance in the United Kingdom

KEY:

- Significantly higher
- Somewhat higher
- About the same
- Somewhat lower
- Significantly lower

North America

Revenue growth from North American respondents fell back last month from 87% to 71% of respondents as several firms reported being caught on the wrong side of the volatile markets.

While all non-bank FCMs reported higher revenues for the month, the performance of banks was more nuanced with small numbers reporting significantly lower revenues related to both trading and clearing losses.

We also found some evidence of weakening conditions for brokerages in the US. While most reported significantly higher revenues, several reported lower revenues, mainly relating to operational challenges posed by the spread of the coronavirus.

74% of proprietary trading firms reported higher revenues, however some options trading firms were hit by the sharp moves in the market and reported significant losses.

CME Group reported a record month of trading volumes with daily volumes (ADV) up to 32.1m - a 68% increase from March 2019. Equity index ADV was up 153% at CME while the OCC reported a new record of 670m contracts cleared.

KEY FINDINGS

- **Some sellside and prop firms hit by volatility**
- **CTA performance tended to be stronger than last month**
- **Volume records smashed as equity contracts hit all time high**

Overall month-on-month revenue rise:

71%

Top performing company type (month-on-month):

Non-bank FCMs

Best asset class:

Equities and equity indices

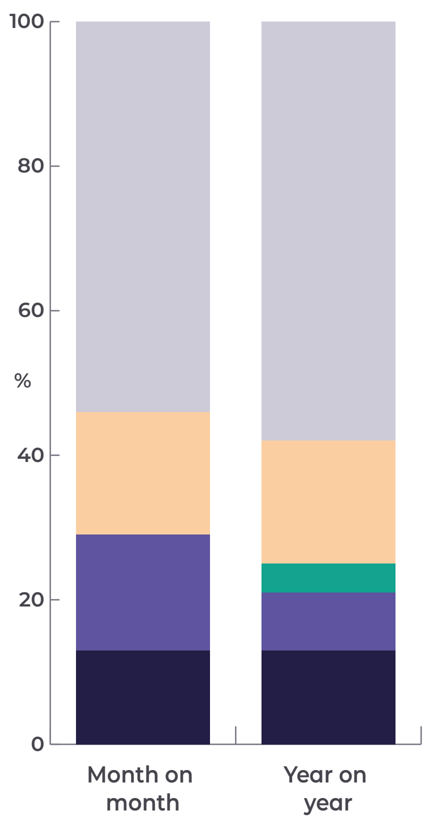


FIGURE 18:
Revenue performance in North America

KEY:

- Significantly higher
- Somewhat higher
- About the same
- Somewhat lower
- Significantly lower

Asia Pacific

Respondents from Asia Pacific posted strong revenues growth last month with 75% of respondents reporting month-on-month revenue growth and 73% reporting year-on-year revenue increases.

Revenue growth mirrored that seen in other regions with a very strong non-bank FCM performance. The sellside overall performed well across the region with performance outstripping peers in other markets, although a small number of brokers reported significant losses.

Proprietary trading firms generally reported a very strong performance although again there were limited reports of losses.

Exchanges across the region reported strong trading with a 41% year-on-year increase in volumes on the Singapore Exchange, 22% on HKEx and Japan Exchange hit a record 82.8m futures and options contracts traded during the month.

Singapore Exchange saw increases in volumes across all asset classes with a 35% increase in equity index volumes, 58% in FX and a 76% increase in its fast growing commodity suite, which investors are increasingly using as a proxy for regional macroeconomic exposure.

KEY FINDINGS

- Sellside outperform in APAC compared to other regions
- Non-bank FCMs lead revenue growth in the region
- Exchange volumes in Japan break records for the second month

Overall month-on-month revenue rise:
75%

Top performing company type (month-on-month):
Non-bank FCMs

Best asset class:
Equities and equity indices

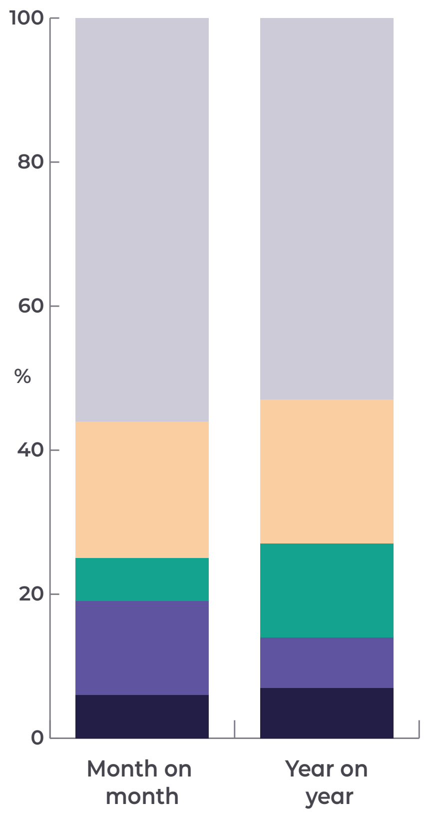


FIGURE 19:
Revenue performance in Asia Pacific

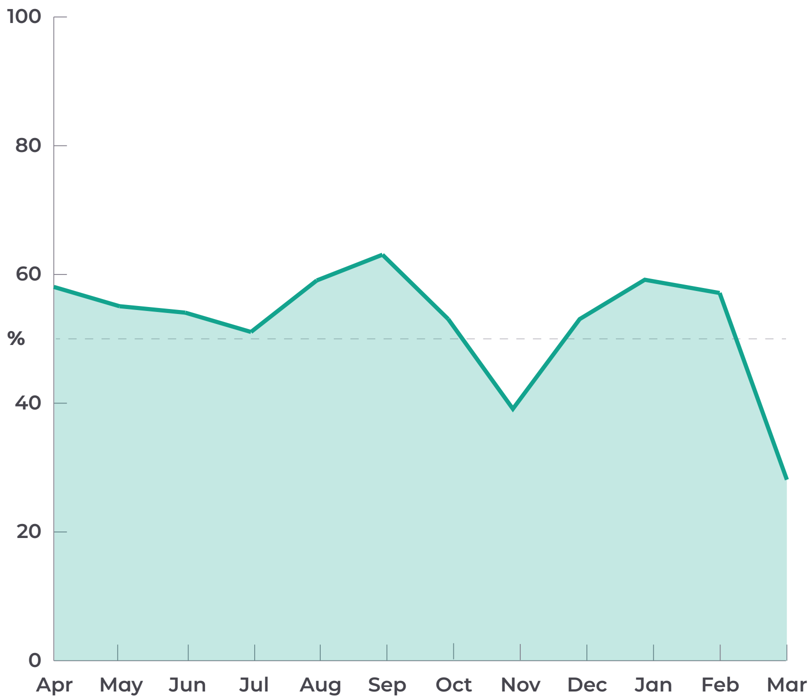
KEY:

- Significantly higher
- Somewhat higher
- About the same
- Somewhat lower
- Significantly lower

SECTION THREE:

Outlook

Outlook over the next three months



The Acuiti Derivatives Sentiment Index

Sentiment dropped sharply again last month to the lowest reading to date on the back of increasing concerns about the long term impact of the coronavirus.

Sentiment fell across all regions and company types. Most notably, the number of respondents thinking that revenues would fall significantly over the next three months rose to 18% of respondents from zero last month.

Respondents in the EU were again the most pessimistic while Asia saw the sharpest falls in sentiment.

FIGURE 20:
Three month revenue outlook by region

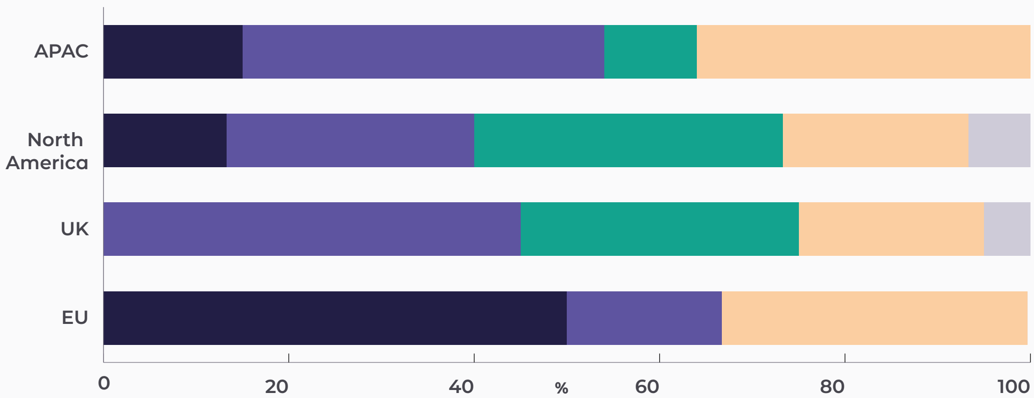
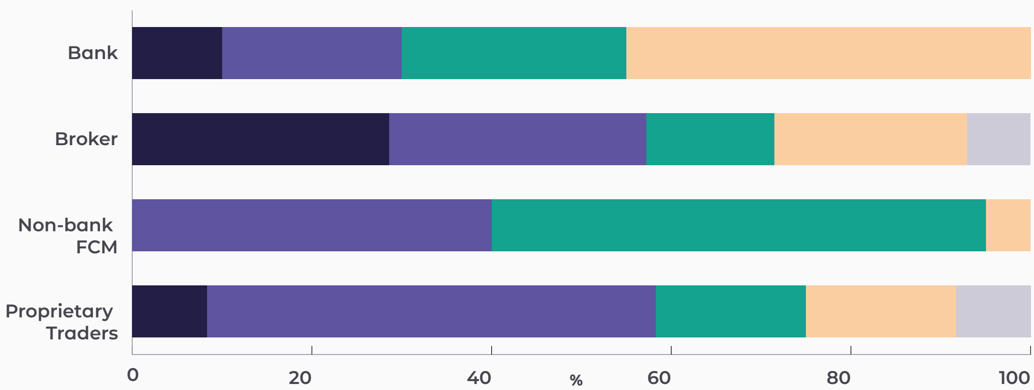


FIGURE 21:
Three month revenue outlook by company type

KEY:
- Increase significantly
- Increase somewhat
- Remain about the same
- Decrease somewhat
- Decrease significantly



SECTION FOUR:

Thought Leadership

Sellside moves to modular technology implementation

In association with:

ITIVITI

Restraints on operations resulting from inefficient legacy technology are one of the major challenges faced by banks offering services to derivatives markets. Modular implementation and the curation of multiple systems provides the answer, says Itiviti.

Since the financial crisis, massive investment has gone into compliance to meet the demands of Dodd-Frank, EMIR, MiFID II and other key pillars of the post-2008 regulatory reforms. Investment in the front office at banks has lagged as a result.

Eyes to the front

Banks today are increasingly turning their attention to investment in the front office looking for a competitive edge and to take advantage of AI, big data and cloud computing - technological advances which have changed the dynamics, cost and investment profile of upgrading front office systems.

"Tier 1 banks with large technology estates containing legacy platforms are increasingly bringing us in to replace or augment some of their internal systems," says Alex Brown, Head of Product, Principal Trading, at Itiviti. "No longer do firms have to build an entire system to gain efficiency in a specific part of the front office, we can work with them to replace specific components or functions."

This represents an evolution of the traditional buy vs build debate. With a more modular approach to installation, you can buy, build and curate. This means that a firm can target a specific aspect of its architecture to improve without a radical overhaul of the whole system.

"A modular buy-and-build dynamic adds more value to the stack," says Alex. "Not every bank operates in the same way or has the same level of investment and they differ in which parts of the stack they need to upgrade, so it is essential for us as a vendor to have the flexibility of offering to accommodate that."

"No longer do firms have to build an entire system to gain efficiency in a specific part of the front office, we can work with them to replace specific components or functions."

Best-in-breed

This modular approach enables banks to focus on where the value add is for their business, buying in commoditised parts of the infrastructure and building around that. It also allows banks to buy the best-in-breed for each component.

"No one provider owns the desktop anymore," says Alex. "Niche providers are coming in offering a specific part of the stack and focusing on that area. Being able to offer software that easily integrates with such technology is key."

Increasingly vendors recognise the importance of building technology that can interoperate and easily integrate with other systems. This trend has been fuelled by initiatives such as OpenFin, which bills itself as "the operating system for the financial services industry" and Glue42, an intelligent desktop integration platform.

"No one provider owns the desktop anymore. Niche providers are coming in offering a specific part of the stack and focusing on that area. Being able to offer software that easily integrates with such technology is key."

Easing the onboarding process

However, integration is only part of the challenge. William Sumner, Senior Sales Manager at Itiviti, says it is essential that vendors understand how Tier 1 banks work in order to make the onboarding process as seamless as possible.

"Onboarding can be made much easier through an understanding of how to navigate the complex compliance and risk processes at large sell-side firms and being able to integrate your product into those systems is essential", he says.

Itiviti is developing AI-based processes to allow firms to more quickly onboard their flow based on historical connectivity data and developing rules to ease the onboarding processes based on that data.

Changing attitudes to cloud-based hosting has been a key factor in easing the onboarding process. 10 years ago, most firms (and in particular banks) were highly cautious when it came to hosting anything offsite. Today there is a far greater acceptance of hosting data and applications in the cloud.

"Cloud hosting is now seen as an enabler rather than an inhibitor. Banks still do thorough due diligence on their providers of course but it is no longer an issue that you are an external provider outside of the banks' internal architecture," says Alex.

Interoperability

This philosophy of integration and interoperability is helping banks to break down the traditional technology silos between asset classes - which have long been a barrier to efficiency - and to reduce the costs of integrating technology across silos.

Taking a modular approach to investment gives banks the opportunity to outsource part of the build of their front office technology while maintaining an edge. It also significantly reduces the total cost of ownership (TCO).

“We see the TCO of front office technology being consistently underestimated for firms that go it alone,” says Alex. “You have the R&D costs, the build and delivery costs, project management and development teams. You have to attract, retain and train the workforce. Then, once built, you have the ongoing maintenance and upgrade costs.

“What is also underestimated is the opportunity cost - how much of a distraction is a full inhouse build? The true cost of ownership needs to incorporate all these costs.”

Finally, there is the risk that things can go wrong amid increased scrutiny by regulators on algorithmic trading and the expansion of the Senior Managers’ and Certification Regime (SM&CR) in the UK. With senior managers now on the hook for potential failures, there is a growing pressure to get everything right.

“A buy-and-build approach allows firms to balance the time to market and investment in technology and people with a focus on ensuring that systems are compliant with increasingly stringent regulatory requirements,” says William.

“We see the TCO of front office technology being consistently underestimated for firms that go it alone”

In association with:

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SECTION THREE:

Contracts and Volumes

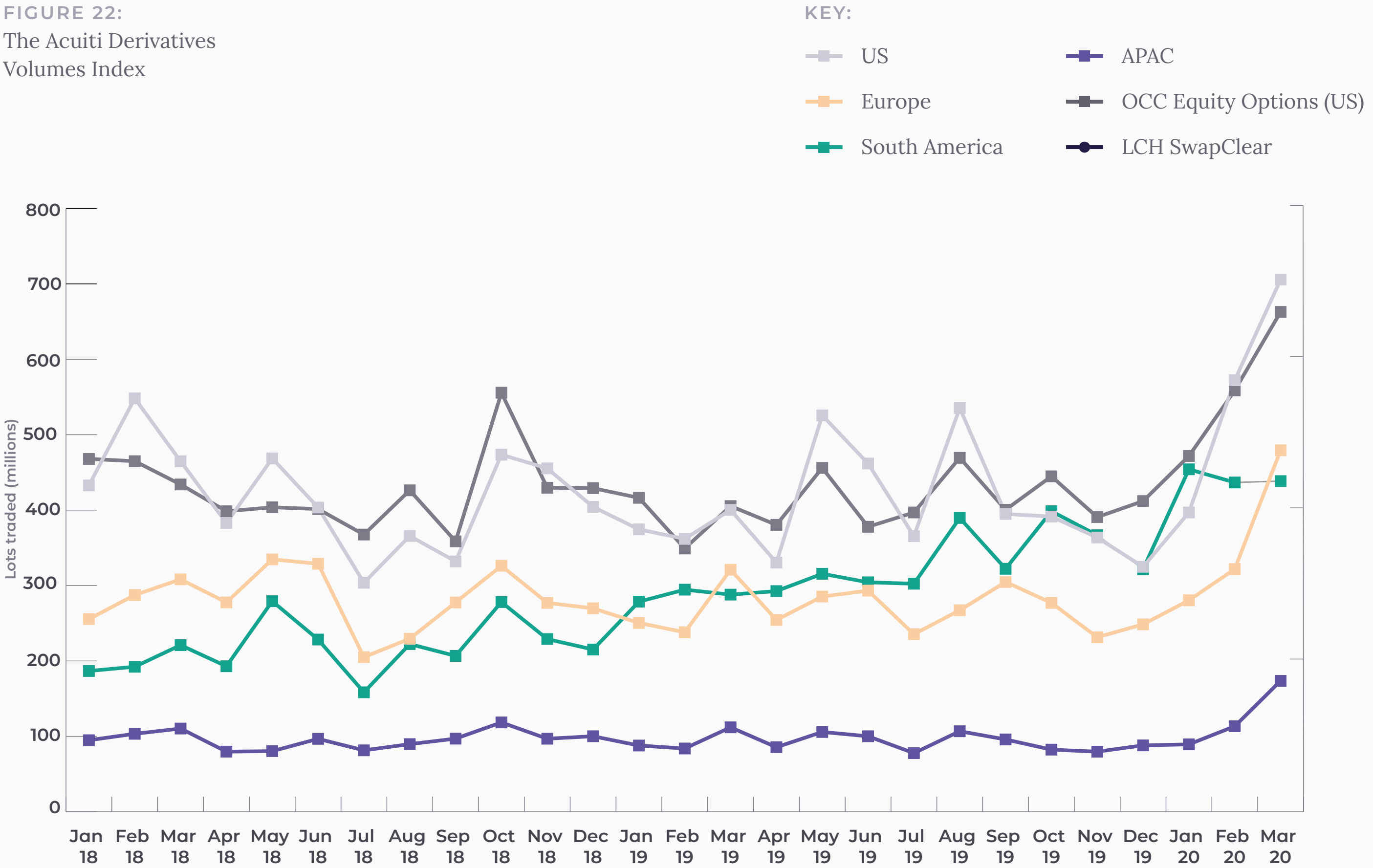
Trading volumes in March

The Acuiti Derivatives Volumes Index is compiled by reference to the overall trading volumes on a series of benchmark, internationally traded, institutional exchanges or CCPs, in each jurisdiction.

The benchmark is designed to provide a measure of overall volumes in each region against which to measure and contextualise regional performance reported in the monthly survey.

Volumes were up sharply across the board in March as volatility gripped global markets. All times highs were reached in almost all major international derivatives markets with equity indices generally seeing the largest increases in trading.

FIGURE 22:
The Acuiti Derivatives Volumes Index



Sources: Euromoney TradeData, ICE, CME, Euronext, Eurex, B3, HKEx, Japan Exchange, LCH, SGX

Most traded and fastest growing contracts

Exchange	Country	Continent	Contract	Contract Type	Instrument	Volume	Open Interest	Contract Size
B3	Brazil	South America	Mini Ibovespa	Equity	Future	199,143,052	1,199,646	BRL 0.2 x index
Moscow Exchange	Russia	Europe	Brent Crude	Energy	Future	109,309,342	962,328	10 barrels
Chicago Mercantile Exchange	United States	North America	Eurodollar	Interest rates	Future	109,077,074	10,792,993	$$2,500 x IMM index
Moscow Exchange	Russia	Europe	USD/RUB	Currency	Future	86,590,028	1,599,116	RUB1000
National Stock Exchange of India	India	Asia	USD/Rupee	Currency	Future	85,746,853	4,862,866	$1000

FIGURE 23:
Most traded contracts in March

Exchange	Country	Continent	Contract	Contract Type	F/O	Volume	Volume Increase	% Increase
Eurex	Germany	Europe	EURO STOXX 50 Index	Equity	Future	77,540,245	44,078,398	57
National Stock Exchange of India	India	Asia	USD/Rupee	Currency	Future	85,746,853	39,776,790	46
Chicago Mercantile Exchange	United States	North America	Eurodollar	Interest rates	Future	109,077,074	38,546,347	35
Moscow Exchange	Russian Federation	Europe	USD/RUB	Currency	Future	86,590,028	34,036,289	39
Chicago Mercantile Exchange	United States	North America	E-mini S&P 500	Equity	Future	78,872,898	32,816,319	42

FIGURE 24:
Top volume increases in March

Volume data provided by: EUROMONEY TRADEDATA

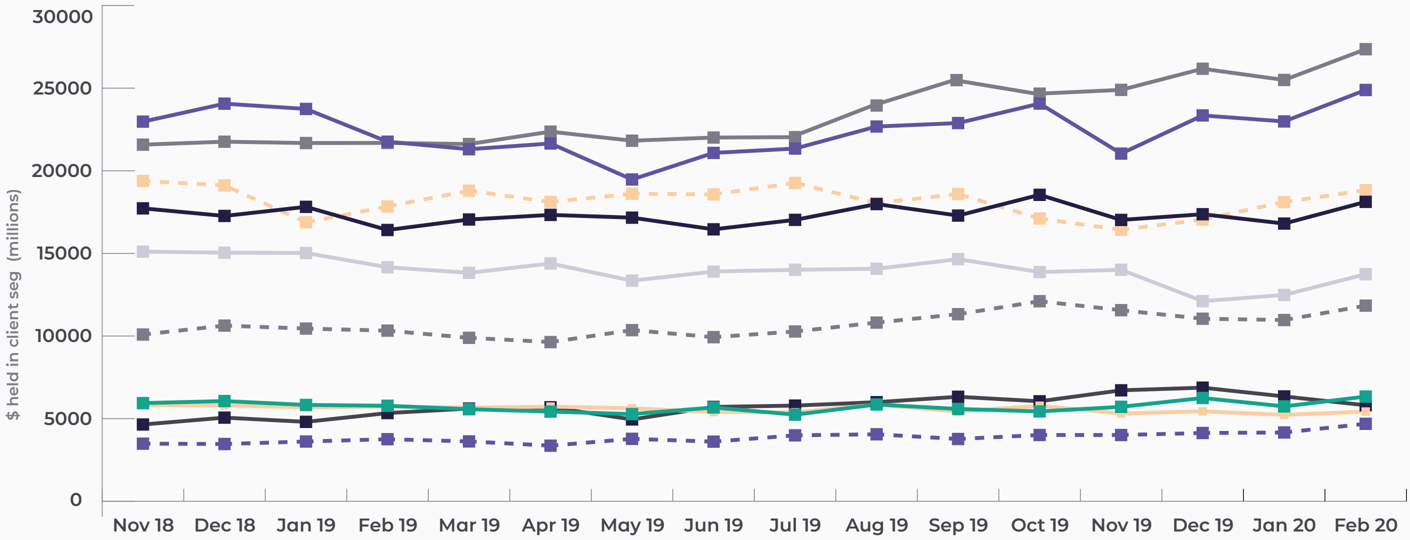
Customer assets held by US FCMs

FIGURE 25:
Customer assets in Segregated fund accounts (Banks)

KEY:

- Goldman Sachs
- JP Morgan
- Morgan Stanley
- BAML*
- Societe Generale
- Citi
- Credit Suisse
- UBS
- Barclays
- Wells Fargo

* Incorporating Merril Lynch Professional Clearing and BOFA Securities



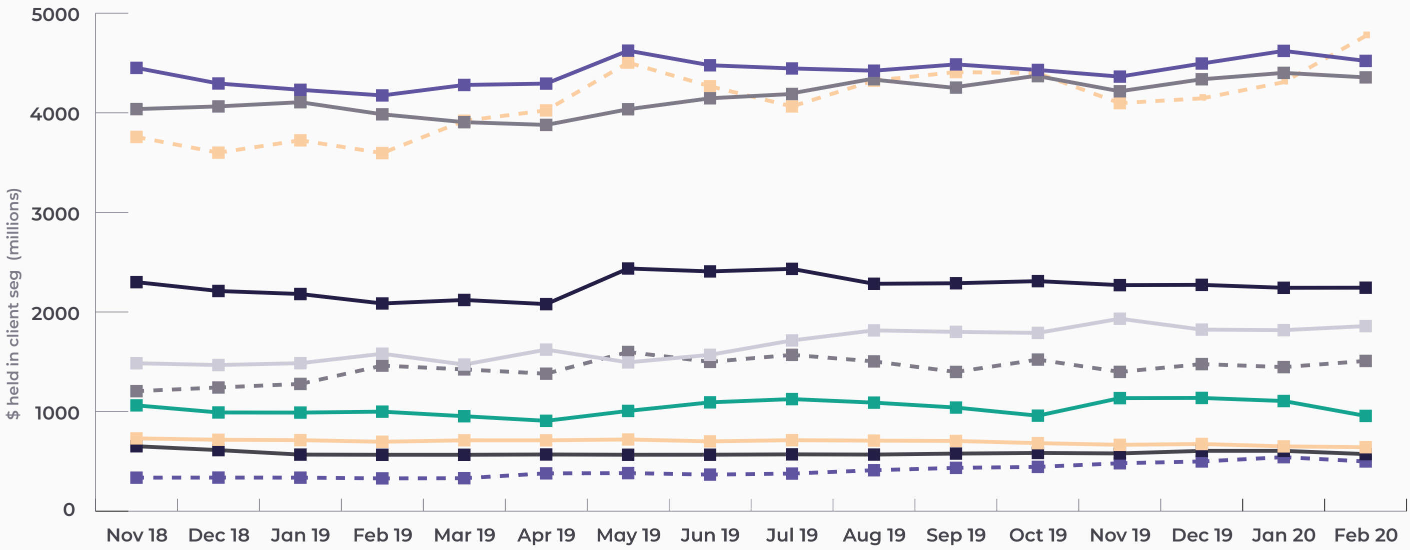


FIGURE 26:
Customer assets in Segregated fund accounts (Non-bank FCMs)

KEY:

- ADM Investor Services
- Interactive Brokers
- RJ O'Brien
- INTL FCStone
- ED&F Man Capital Markets
- Marex North America*
- Wedbush Securities
- McVean Trading & Investments
- Tradestation Securities
- Phillip Capital

* Formerly Rosenthall Collins Group

Source: CFTC

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