acuiti management intelligence

The Growing Opportunity in Derivatives Clearing

Why rising volumes and higher interest rates will bring new entrants to the market

In partnership with ION

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Shifting trends for FCMs

After the 2007/2008 great financial crisis, central banks embarked on a cycle of rate cutting and monetary stimulus that held interest rates in advanced economies at zero or in some cases, in negative territory, for a decade. At the same time, the "Central Bank Put" reduced volatility across global markets.

This had profound impacts on many corners of financial markets. One of the most affected has been the Futures Commission Merchant (FCM) business model. Prior to the zero-interest rate era, meaningful FCM revenue came from the net interest income that firms earned on client margin. This was a significant percentage of firms' income, with estimates putting the amount at one quarter to a half of clearing firms' revenues.

The rapid pace with which Central Banks across the globe cut rates towards zero from 2007 onwards decimated this revenue stream. At the same time, the reduced volatility saw volumes plummet in many key and once lucrative contracts for clearing firms such as interest rate options.

In a relatively short period of time, the FCM landscape became much more challenging. Many firms fought to keep or build market share by cutting commissions, but this had the net effect of driving down revenues across the industry - further reducing the ability for firms to profit, especially in the face of falling volumes.

In response, many firms dropped out of the market all together, unable to make the economics work any longer as zero and negative interest rates and low volumes rolled on from year to year. As a result of consolidation and the withdrawal of firms from the market, the total number of FCMs globally has fallen from 170 before the financial crisis to 70 today, with smaller FCMs in particular pulling back from the market.

The dynamics are finally shifting, however. After a decade of struggling, the economics of the clearing business have rapidly improved. One driver of this turn has been central banks' aggressive interest rate rises over the last 12 months, which have added hundreds of millions of dollars to the industry's revenue globally.

Another key driver in the reversal of fortunes for FCMs is the rise in derivatives volumes in recent years. FIA data shows that over the last five years, exchange traded derivatives volumes have risen from 25.2bn contracts in 2017 to 83.9bn contracts in 2022.

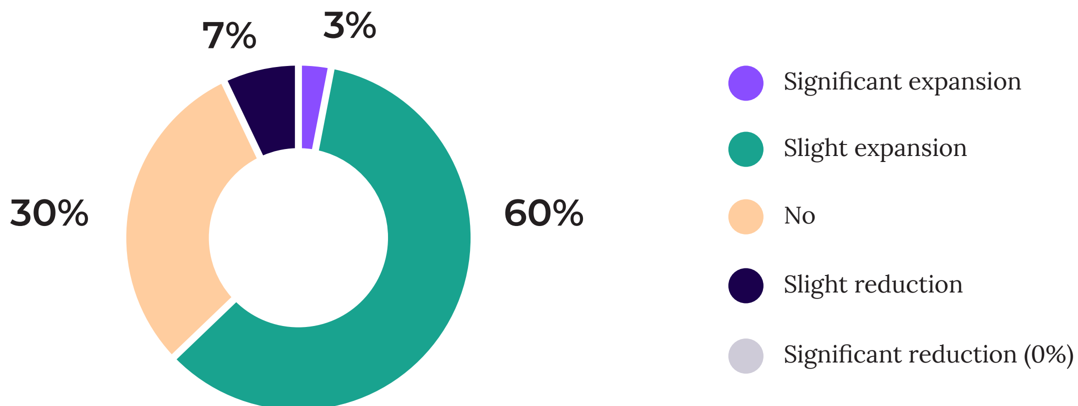
The twin factors of rising interest rates and higher volumes have had a profound effect on the economics of the FCM clearing business. It is driving incumbent firms to expand their coverage and reach. Additionally, a diverse range of new entrants are looking to come into the market based on the economics and niche opportunities in the market.

ION commissioned Acuiti to further examine these trends, their future course and how firms today can best position themselves to take advantage of the opportunities in clearing. For this study, Acuiti has surveyed or interviewed senior executives at 61 sell-side firms across the market.

Expanding clearing horizons

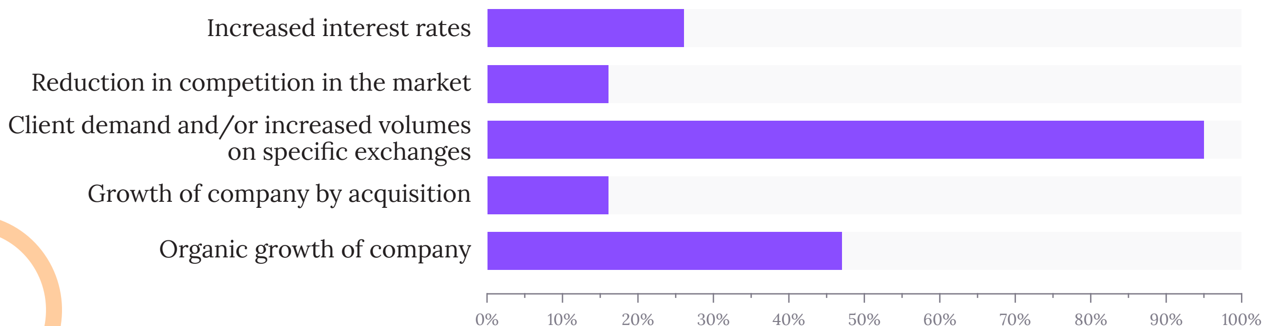
The increased volumes and hundreds of millions of dollars of additional revenue in the market is resulting in incumbent FCMs seeking to expand their offerings. Almost two-thirds of FCMs that took part in the study said that they were planning to expand memberships over the next three years. Interestingly, the percentage of firms seeking to expand memberships was broadly similar across all company types, although non-bank FCMs and Tier 1 banks were marginally more likely to be planning an expansion than Tier 2 banks and regional banks.

Are you planning on changing the number of clearing memberships you have in the next three to five years?



The main reason for the expansion of clearing memberships was client demand, organic growth opportunities and increased interest rates.

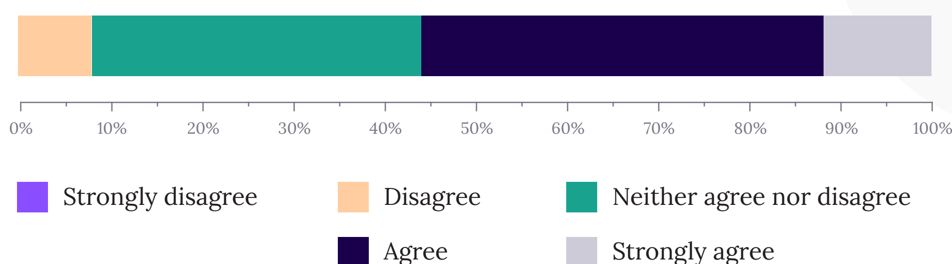
What factors have led to your decision to increase the number of clearing memberships?



Significantly, this study found growing confidence in the market that the higher interest rates are here to stay. More than half of respondents said that their house view was that rates would remain high for long enough to make medium to long-term decisions about business expansion. Even if rates do come down over the coming years, most FCMs are secure in their revenue streams emanating from interest rates (see boxout on page 7).

Do you agree or disagree with the following question:

We believe that interest rates will remain high for long enough to expand our business with confidence



However, the case for expansion is not solely dependent on rising interest rates. Instead, there are other strong trends encouraging expansion among FCMs with growing volumes in emerging markets playing a big part of the story of growing attractiveness in offering clearing services.

Survey respondents said that they were working to become members of a variety of exchanges and CCPs in the next three years, including Chinese, Brazilian, Mexican and Polish exchanges, as well as some new regulated cryptocurrency markets.

Incumbent FCMs currently have the chance to create a virtuous circle from interest income. Using the funds from interest income to expand into new markets adds new clients with new funds to post, which increases the client balances that FCM's can earn interest income on.

However, the study identified some challenges for bank respondents over non-banks. While the tailwinds of increased interest rates and higher volatility is a boon for the clearing industry overall, the underlying economics driving those trends presents challenges for the wider economy and, as such, other business lines of larger sell-side firms are feeling the negative consequences of higher rates.

Overall, a third of respondents said that more challenging conditions in other areas of their firm are likely to reduce investment budgets for clearing. However, just 8% of brokers and non-bank FCMs said that was the case compared with almost 75% of regional and tier 2 banks.

New entrants

While incumbent FCMs are expanding their offerings is one key trend identified in this report, another is growing interest from firms entering the market. This promises to reverse the decade-long decline in the number of FCMs and to create new competition in the market.

In the years after the financial crisis, only a handful of firms adopted FCM licences, most from a similar background such as TD Ameritrade, Charles Schwab and E*Trade. However, these new entrants were outweighed by the exit of other FCMs through withdrawal from the market or consolidation in the wake of the financial crisis.

This study found that, as market conditions become more favourable to the clearing business model, interest is growing among an increasing and diverse range of companies including crypto exchanges, retail brokers and, in limited instances, institutional brokers specialising in areas like commodities and seeking one or two memberships, such as the LME, to increase their offerings in their core business.

The survey found a strong and clear sentiment that increased competition among FCMs would benefit the overall market — pointing to market participants' belief that the clearing market structure needs more firms offering services in this area, especially considering the rising volumes in the market and minimising some of the concentration risk that has built up among the largest FCM's

Opinion was more mixed on whether increased interest rates were likely to attract new FCMs to market. However, interviews reveal that new entrants are moving to take advantage of the opportunity, with funding secured to do so, and are at various stages of adoption.

Do you agree or disagree with the following questions:

Increased interest rates are likely to lead to new FCMs coming into the market

Increased competition from other FCMs would be of benefit to the overall market

0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

Strongly disagree | Disagree | Neither agree nor disagree | Agree | Strongly agree

The rapid growth in crypto markets over the past five years has gone some way to forging a new market structure for derivatives trading in which exchanges also operate as FCMs. A model pioneered by the now-defunct exchange FTX, it has not gone away with the collapse of the firm, though it is not favoured by US regulators.

Coinbase has an application to operate an FCM in the US and other crypto exchanges are understood to be planning to take a similar approach, despite recent challenges from the SEC. Elsewhere, CME – once the arch-critic of the exchange ownership of FCMs has applied for an FCM licence and the holding company that owns MIAX acquired FCM Dorman Trading last year.

A previous study by Acuiti and ION found strong demand from native crypto markets to expand into traditional asset classes in due course so while these initial FCM approvals, once granted, will likely be initially used for cryptoassets, they could ultimately expand to offer competition in traditional markets. In addition, recent new entrants to the FCM landscape in the US such as Bakkt Clearing and Hidden Road come from the crypto markets.

Elsewhere, new retail trading platforms are likely to follow in the footsteps of their peers in establishing FCMs and expanding their offerings into institutional markets once their clearing services are established.

FCMs seek to expand their interest revenues

The rapid rise in interest rates over the past 12 months has created significant additional revenue streams for FCMs. However, many are looking to increase their spreads to grow revenues further.

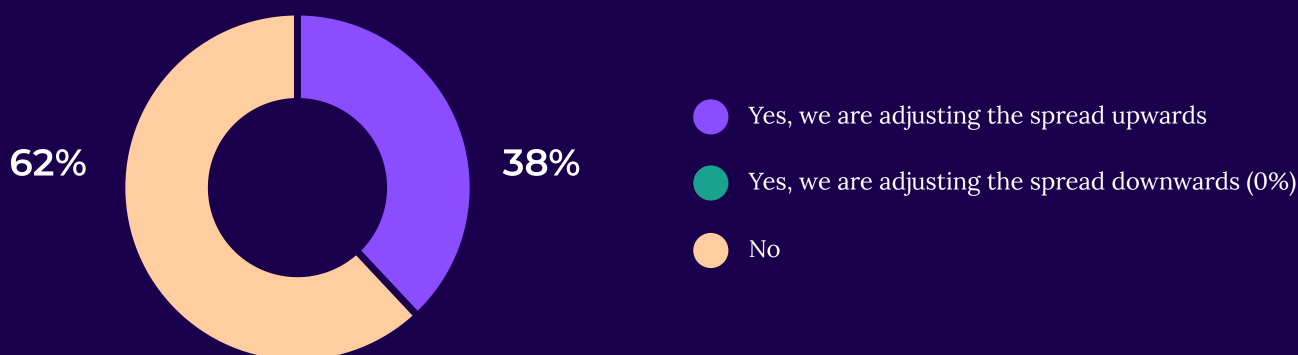
During the period of historically low interest rates, there was virtually no interest income for any parties. FCMs typically offer clients a spread on the margin they hold on their behalf which is calculated at an agreed rate below the interbank rate.

These rates vary but a typical spread would be around 75-150 basis points. When rates are 0.5%, the client gets no interest at all. However, once rates rise above 1-1.5% (depending on the spread offered), the client will start to get a rebate.

Based on FIA CCP data which shows the level of margin held a the major global CCPs to be just over $1tr, the proportion of cash collateral held by FCMs on behalf of their clients is expected to be worth hundreds of millions of dollars in interest income.

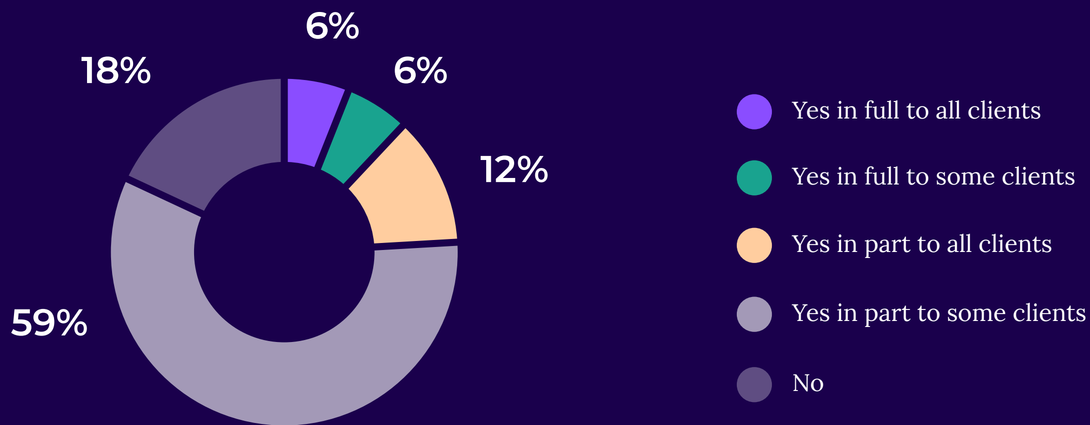
Now with central bank rates in excess of 4% in many major jurisdictions, clients are seeing significant rebates. In response, FCMs are seeking to increase the spread. This study found that 38% of respondents were looking to increase the spread they charged clients. This included almost half of tier 1 banks.

As interest rates rise, is your firm considering adjusting the interest spread you charge on client balances?



At the same time, FCMs said that they were passing on the increased cost of capital to clients with 82% of respondents saying that they were at least in part to some clients charging extra for the cost of capital.

Are you passing on the increased cost of capital to your clients?



The significance of the interest rate increases is that under current models for charging spreads on client funds outlined above, FCMs are well hedged if interest rates fall slightly from current highs as the economy weakens. It would take a fall of rates to below 2% before most FCMs see their revenue streams from interest income eroded.

Hurdles to entry

Despite the opportunities emerging in the cleared derivatives space, the path to offering FCM services can be an onerous one. For FCMs already active in cleared derivatives, the process of onboarding to new exchanges and CCPs can be a multi-year one. Technology connectivity, licence fees with vendors and a host of legal fees are all significant sunk costs.

Operational costs are also high, with training required to ensure staff are able to manage clearing processes with different CCPs. Other costs to consider are default fund contributions and other upfront costs that are often tied to new memberships.

For firms adding new asset classes, getting the right risk management systems in place is also an essential step. Interviews for this study indicated that investment here is currently focused on middle and back-office systems, where firms have to decide how to margin and risk manage clients on new markets.

In this respect, there was a clear desire to move risk management to intraday monitoring and away from end-of-day calculations. There was a hope that investment in this area could come from interest income, after a near decade of underinvestment or investment focused more on solving issues rather than innovation.

The biggest issue for new entrants, however, is the capital requirements of operating a clearing business, which sets a very high barrier to entry. Among the few firms that took part in the survey that were planning to reduce the number of memberships they had, cost of capital was the most commonly cited reason for the retreat.

Post the financial crisis reforms and new rules such as SA-CCR have, in many instances, increased the capital required to run clearing businesses and continues to put pressure on existing firms and create a hurdle for new entrants.

Technology as an enabler

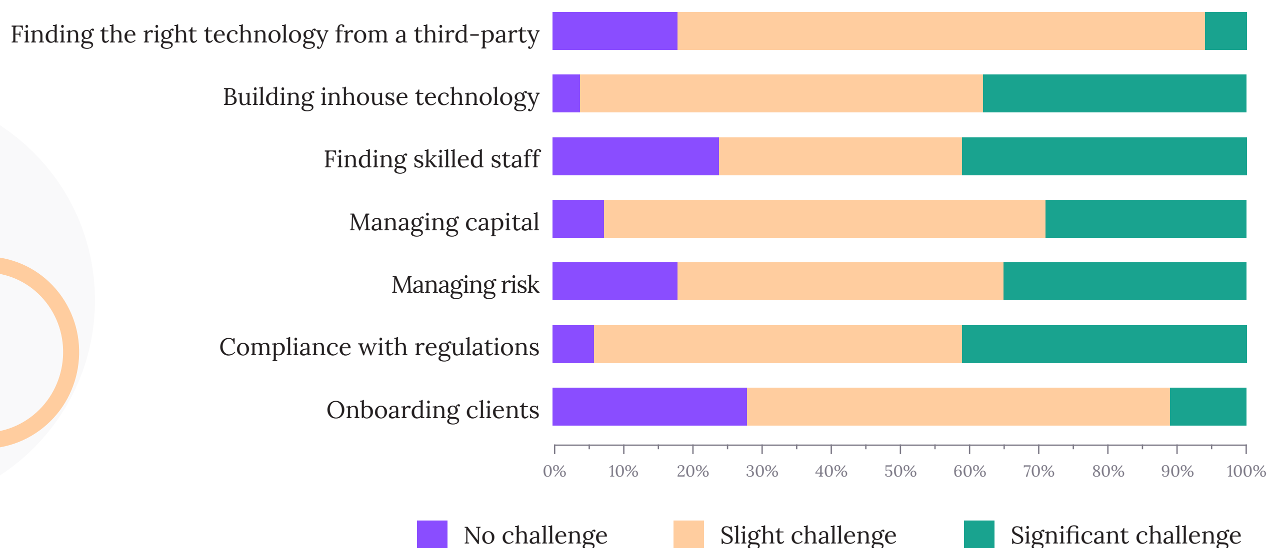
For sell-side firms that were not considering developing a clearing business, the costs of technology required to offer clearing services was the third most commonly cited reason after capital rules and lack of client demand.

But the technology investment required to start out in clearing does not have to be a barrier. The quality of third-party software for post-trade, margining and derivatives clearing is among the best in the industry and some providers offer an-off-the-shelf solution that smaller firms looking to enter the market without the investment requirements associated with traditional infrastructure can leverage to rapidly connect into industry infrastructure and get up-and-running.

As demonstrated in the chart below, building inhouse technology is significantly more challenging than finding the right third-party partner and new entrants to the market will likely take the latter route to market.

More recent entrants into clearing that Acuiti spoke with for this report that had built inhouse cited the long and onerous process of building inhouse systems for trade processing and compliance. Some firms have begun running into legacy problems only a few years after they began building systems from scratch and end up having to manage the burden of all exchange mandatory development on their own.

How great a challenge are, or do you expect, the following will be as you expand your clearing memberships?

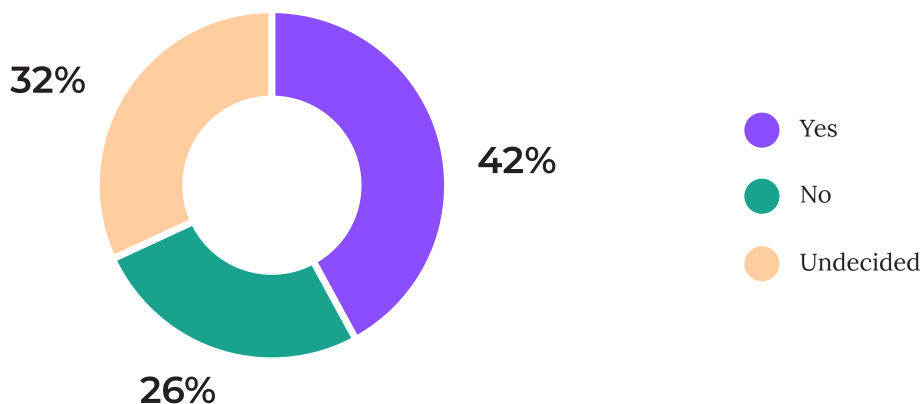


This challenge is exacerbated by the complexity of regulations and their susceptibility to change. It is then compounded by issues finding and maintaining staff who can stay on top of developments such as changes to regulatory reporting requirements, which cause significant headaches for inhouse development teams.

The ability to scale up and add new markets as quickly as possible to an FCM's offering is a prized asset for firms that are looking to either expand existing offerings or enter clearing as new entrants.

While many existing FCMs are looking to address a decade of underinvestment and improve their systems, new entrants are faced with the opportunity of coming to market with the latest technology, providing them with an edge as they start to grow their operations.

Are you planning on investing in new technology from a third-party to support the growth of your clearing memberships?



The survey found that almost half of respondents that were expanding the number of clearing memberships they have are planning on investing in third-party technology to support the growth of their memberships. The most common areas that firms were looking to outsource were transaction matching, margin and collateral management and reconciliations.

Conclusion:
Good times ahead for FCMs

The twin tailwinds of rising interest rates and higher volumes has dramatically changed the economics of clearing. This is resulting in existing FCMs seeking to expand their operations and client offerings to new markets.

In addition, it is seeing new entrants looking to enter the market. While many of these new entrants are related to cryptoassets and seeking FCM registrations to innovate in market structure and offer services in this sector, the diversity of new entrants is higher than it has been for years.

The market needs more FCMs.

In almost every area of the market, the choice for firms has reduced significantly since the global financial crisis. For some firms, such as proprietary trading and smaller hedge funds, the reliance on a smaller number of providers presents a major risk to their operational models.

For firms seeking to enter the market for the first time or re-enter the market after a withdrawal over the past decade, technology should not be a barrier.

While capital rules are likely to continue to raise the barrier to entry, third-party technology offerings provide a quick and cost-effective route to market for many firms.

The opportunities for FCMs are likely to expand further in the coming years as interest rates remain high and volatility continues to stalk global markets. This is likely to result in increased competition among FCMs, which should benefit end clients and the market as a whole.

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