acuiti management intelligence

State of the Market: FCMs' Front-Office

Investing to increase efficiency and operational resilience

IN ASSOCIATION WITH

Broadridge®

Table of Contents

Introduction

With rising costs, regulatory complexity and increased client demands, the Future Commission Merchant (FCM) front-office is an arena of constant change.

Execution desks have to invest in their technology infrastructure in lock-step with a variety of client demands and operational and regulatory requirements, while keeping their services as price competitive as possible.

This is playing out in an environment of constant cost concerns, with desks facing rising expenses from factors ranging from regulation to market data.

This makes investment in the front-office a delicate balance. FCMs across the tier structure are under pressure to allocate budget efficiently in technology that services clients while also keeping costs down in more mundane parts of the stack.

Adding to the complexity of front-office investment, the EU's Digital Operations Resilience Act will raise the bar substantially on FCMs in their front-office back-up and operational resilience requirements.

To explore the challenges of building and maintaining competitive front-office offerings in the current climate, Acuiti has partnered with Broadridge to survey or interview senior front-office executives at 38 of the major FCMs.

This report consists of three parts. Firstly, we take a look at the competitive landscape and ask where firms are facing challenges in growing their front-office execution business. Secondly, we analyse the current state of play in terms of how FCMs approach technology sourcing and investment.

Finally, we look at how FCMs are meeting these challenges with investment and where firms are looking to build to service the market of tomorrow.

The key findings of this report are:

- FCMs are increasing front-office investment to meet the demands of competition and increase operational resilience
- OMS consolidation across asset classes is being targeted by almost half of firms to improve operational efficiency
- Data integration across the front-to-back trade workflow remains a key challenge for firms
- Fees are becoming less of a competitive edge as FCMs leverage customer service, algorithms and technology to compete

Part 1

The competitive landscape

While competition among FCMs in their clearing businesses has remained broadly stable, or even reduced over the past decade, competition in listed derivatives front offices has increased. New entrants to the market in the form of electronic liquidity providers and a wide range of specialist brokerages have kept competition for execution businesses intense.

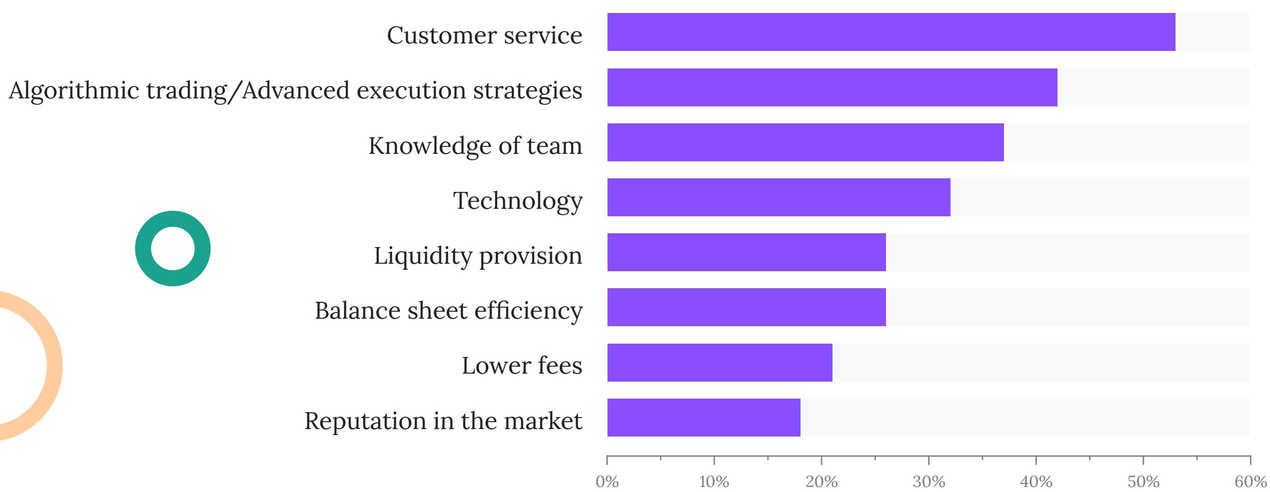
Most participants in this survey considered their USP to be customer service. This in part reflects the value of expertise and market knowledge— which ranked high as a standalone category.

Algorithmic trading is also a key area where many firms are seeking to differentiate themselves from competitors, and one that is only growing in importance. While about a fifth of respondents cited lower fees as a competitive edge, executives interviewed for this report were sceptical as to how much lower fees could go across the industry after a period of significant compression over the past decade.

This fee compression has forced FCMs to do more with less. In addition, it has resulted in firms looking to offer value over and above execution services.

With non-bank liquidity providers and specialist brokers providing tight pricing in specific markets and contracts, FCMs have looked to expand their offerings and provide additional services and expertise to clients in order to remain competitive.

What do you think are the biggest selling points of your derivatives trading or execution business against your competitors? (select up to 3)



This trend is likely to continue. As execution desks consider how to place themselves competitively for the future, many are emphasising global risk management, as well as global venue and market coverage.

This is synonymous with the push into new markets that many execution desks are pursuing as they seek new sources of revenue and to expand their client base across different regions.

Rank these elements according to their importance to your derivatives execution business

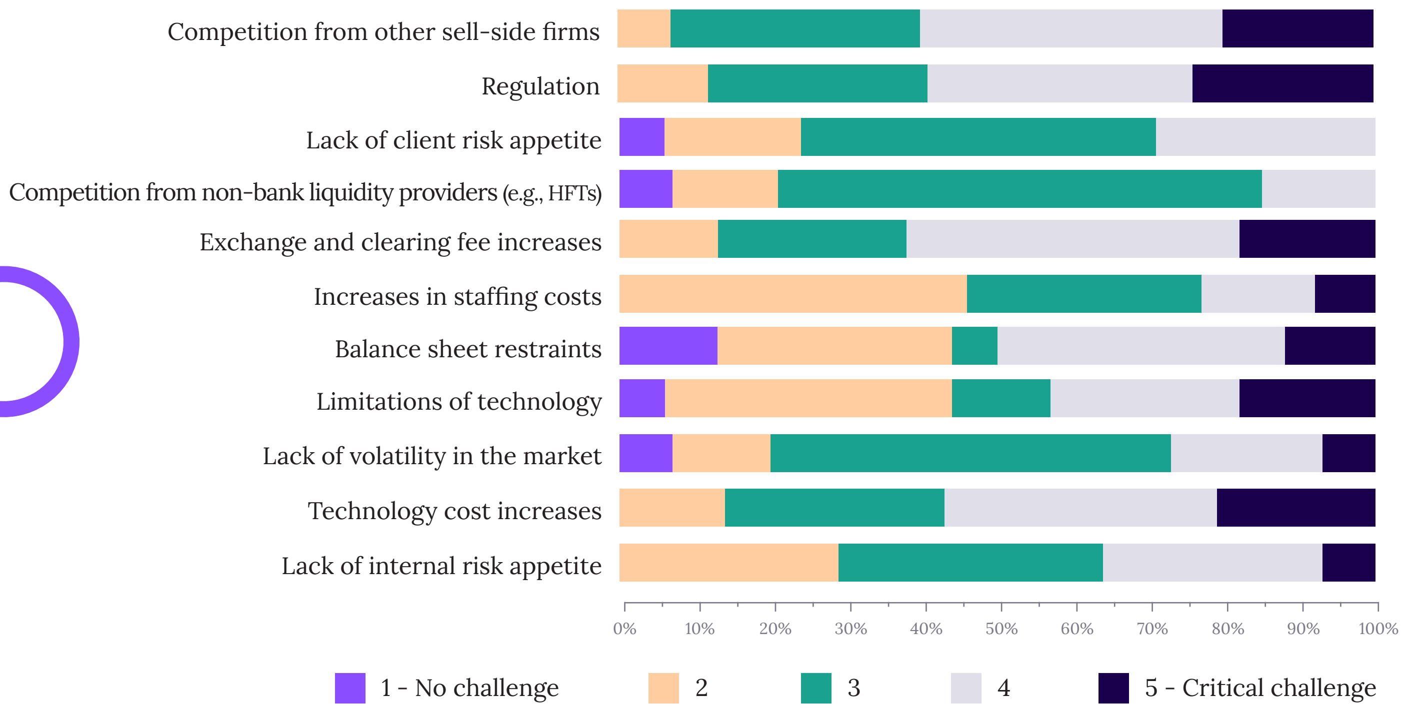
1. **Global risk management**
2. **Global venue/market coverage**
3. **Algorithmic trading execution performance**
4. **DMA latency**

An essential element of competitiveness is dealing with challenges as efficiently as possible. Over the last 12 months, regulation has proven to be one of the most critical challenges to FCM front-office profitability.

On a weighted basis, competition from other sell-side firms was the most pressing challenge for firms. However, competition from non-bank liquidity providers was also significant and a challenge that is likely to grow as these firms expand their services further into listed derivatives.

Executives interviewed for this study also reported significant costs incurred from constant exchange and clearinghouse upgrades, adding to cost pressures from these venues, which already levy significant charges, particularly in terms of market data fees.

To what extent have the following factors have posed challenges in maximizing profitability for your front office derivatives business over the past 12 months?



Elsewhere, it appears that the wage pressure that hit the industry after the pandemic is subsiding as a challenge for firms, in part as the major banks cut back on hiring. The past five years have seen periods of intense volatility, so it is little surprise that a lack of volatility features lower down the list of challenges.

However, volatility presents both challenges and opportunities for execution desks. While it brings increased client flows and opportunities to profit, it also presents operational challenges, particularly with regards to risk management.

The complexity of pre-trade risk has increased over the past four years in the wake of the increased volatility, with controls having to monitor for new risks, such as margin and PnL in addition to larger intra-day swings. Front offices also have to contend with an increase in overall trading volumes, as well as the increasingly broad range of products that clients now trade, which adds correlation risk to the mix.

Current technology set ups: OMS, EMS and Algorithms

The breadth and complexity of front-office set-ups vary significantly from firm to firm. Some organisations have invested in consolidation and simplification. For others, the flexibility enabled by multiple systems is prized. In this section, we take a look across current technology set-ups, expectations of change and how firms are sourcing technology. Finally, we turn to how firms are investing in the future in Part 3.

OMS

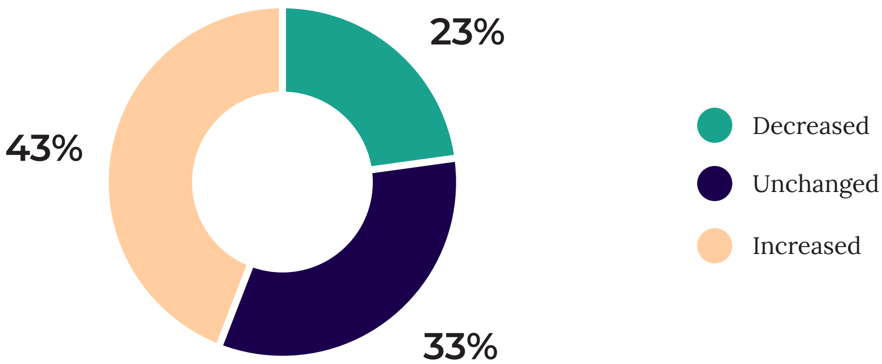
The number of Order Management Systems (OMS) that FCMs use in the front-office is varied. About a quarter of survey respondents only used one OMS while most operated multiple systems.

OMS usage reflects the significant variation between the business models of global banks. Some run a siloed business model, while others pursue as unified an approach to platforms as possible.

Around a quarter of survey respondents had reduced the number of OMS applications that they used during the past three years.

However, the overall tendency among survey respondents has been to either maintain the number of systems they use or add new ones.

How has the number of OMS systems you use changed over the past five years?

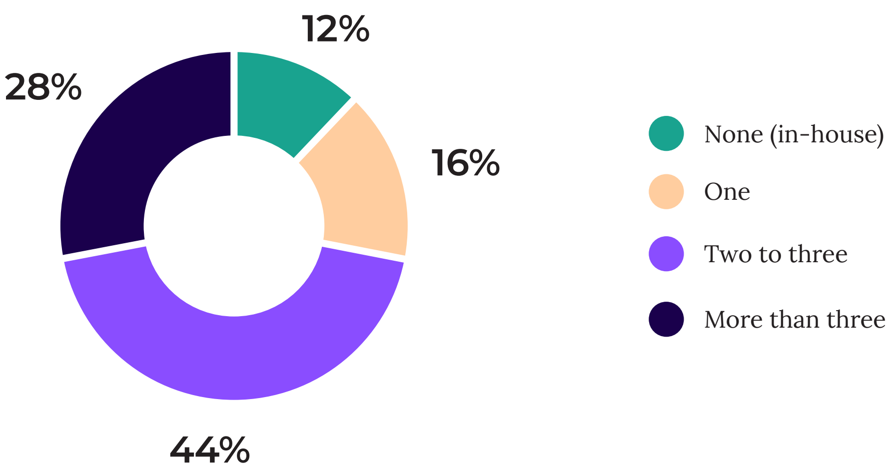


When asked where they would like to see change in their OMS, survey respondents cited improved scalability and market coverage, as well as better reporting and monitoring abilities. FCMs also wanted simplified pre-trade risk management functionality and a more streamlined tech stack, with fewer points of failure.

EMS

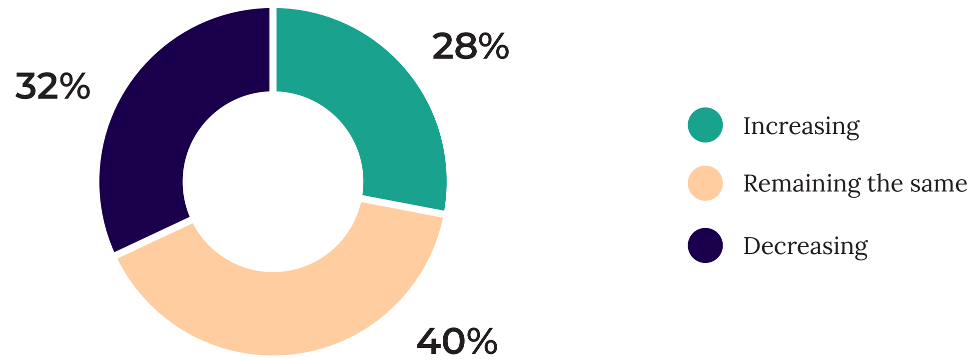
Only a small proportion of survey respondents had chosen in-house development for their EMS, confirming the significant shift to outsourcing over the past decade. The majority used vendor platforms, with the largest proportion using two to three vendors.

How many EMS vendors do you use to provide execution capabilities to your agency execution desks globally?



Almost three quarters of survey respondents expected that the number of vendors they work with would remain stable or decrease over the next five years. However, just over a quarter expected an increase over the same period.

How do you see this changing over the next five years?



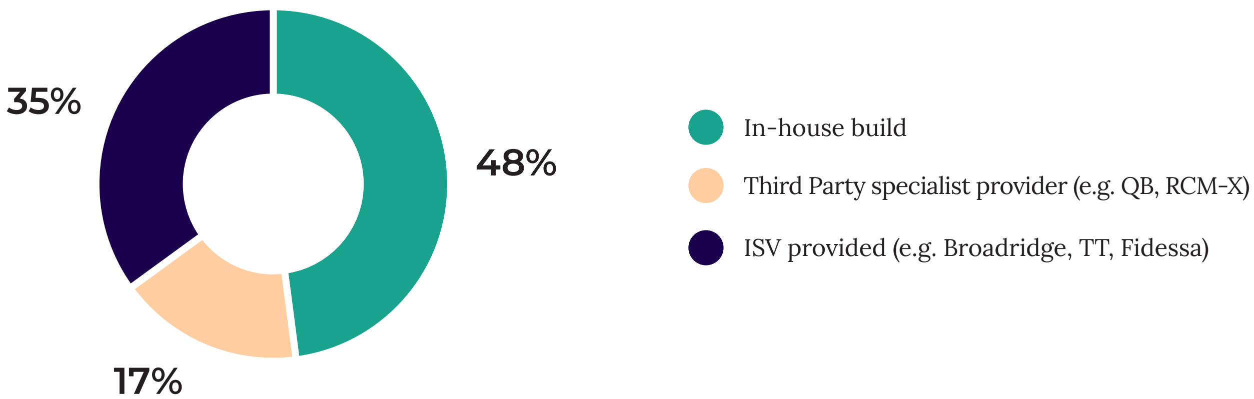
As mentioned above, execution desks prize cost-efficiency, and this was ranked as the most important factor in their agency derivatives execution operations. Risk management was also highly valued, with increasing demand from clients for functionality such as pre-trade risk controls. Survey respondents cited execution tools and algorithms as areas where they would like to see improvements in the EMS offerings, as well as better charting and analytics.

Algorithms

Algorithms' speed and ability to handle complex client demands have increased enormously in recent years. A significant part of this story has been the expanded range of third-party algorithms, which have increased in sophistication and customisability. This has made many FCMs comfortable with outsourcing algorithm provision.

For nearly half of survey respondents however, inhouse algorithms are seen as a key differentiator against the competition. These firms still often have to cater for client-provided algorithms and third-party offerings, where requested, but operate these offerings alongside a clear strategy to push forward inhouse solutions.

What is your strategy for the provision of complex execution algorithms to your agency execution desks?

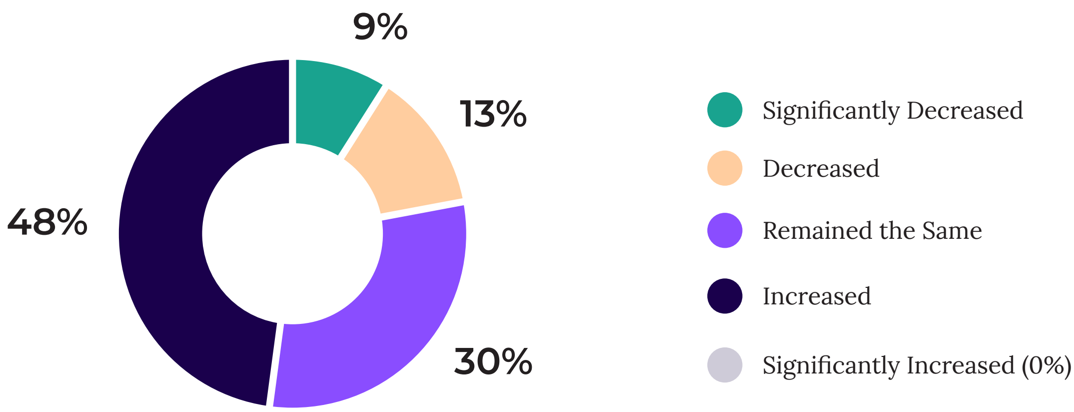


Part 3

Investing for the future

Almost half of FCMs are increasing their investment in the front office. Overall, 48% of FCMs reported an increased budget for the coming 12 months while only around a fifth reported lower budgets — a sign of the imperative of maintaining a competitive offering in the front-office and the drive to invest to increase efficiencies, as well as FCMs' preparations for the EU Digital Operations Resilience Act.

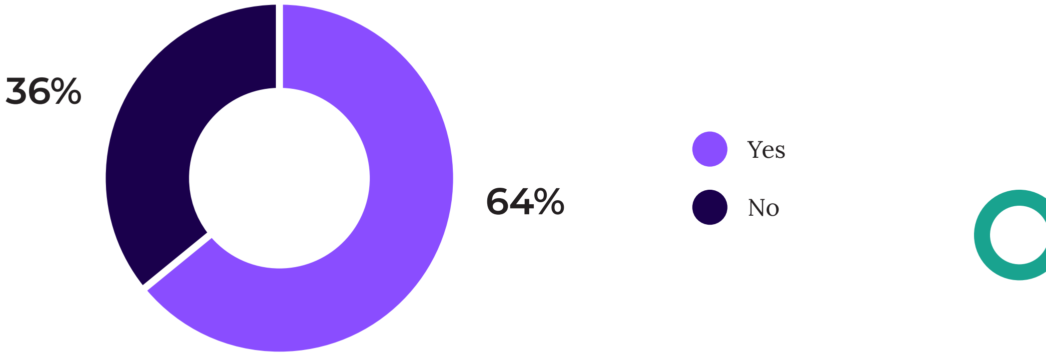
How does your budget for front office technology investment over the next 12 months compare to an average year?



Cross asset consolidation

This focus on investment to increase efficiency is resulting in firms looking to consolidate workflows across asset classes. The rising popularity of multi-asset trading desks on the buy-side has been a major theme of recent years. Most survey respondents thought there was a need for a multi-asset deployable screen for buy-side customers.

Do you see the need for a multi-asset deployable screen to your buy side customers?

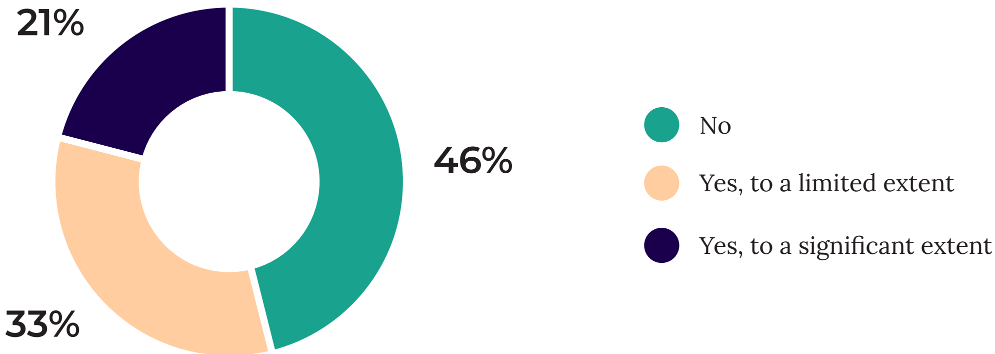


What form providing cross-asset services takes can vary greatly across the sell-side. Some larger banks do not want to modify their structure and consolidate systems onto a single execution platform.

This is often because the high level of volume and risk that they process by asset class is perceived as too great for one platform to handle. Other execution desks simply operate a siloed model and do not see internal impetus to change. This is not a universal view, however. Many other firms have ambitions to consolidate their trading operations as much as possible.

These organisations see considerable advantage in areas such as data analysis, with a unified platform being seen as the most efficient way to normalise data and provide high quality cross-asset analysis, as well as improving risk management.

Are you planning to consolidate front-office OMS technology across asset classes?



While there has been progress in merging EMS across asset classes, significant differences in order workflows make the consolidation of OMS more challenging.

However, third-party vendors have been investing significantly in this area and new products are coming to market that enable firms to consolidate.

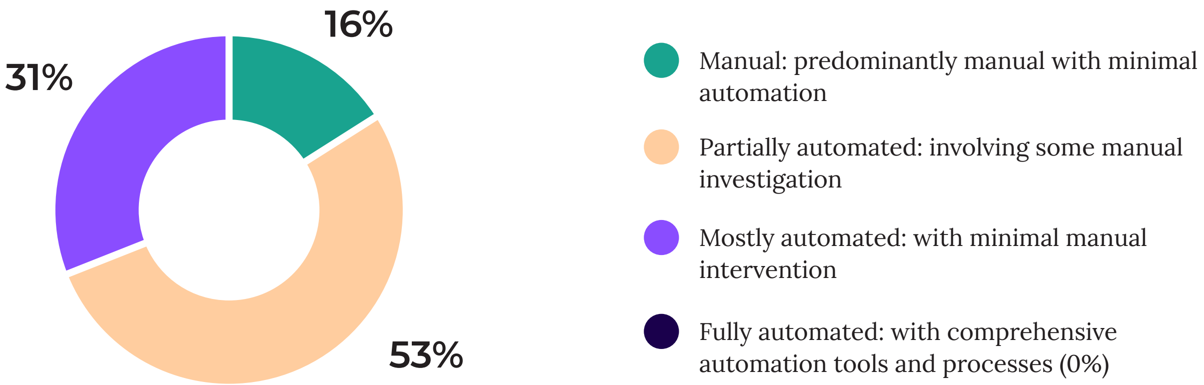
Improving post-trade efficiency

A key facet of cost reduction in recent years has been investment in automation, with a particular focus on middle and back-office issues such as trade breaks.

Despite much investment and focus in this area, no survey respondent reported fully automated handling of trade breaks, with 16% still handling trade breaks as a predominantly manual process. About a third were mostly automated while just over half ran processes that still involved some manual investigation.

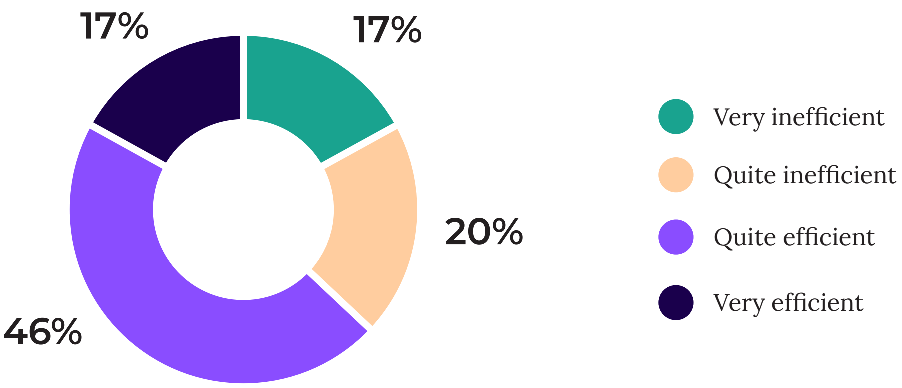
Despite no-one achieving full automation, getting as close to it as possible is a priority for most FCMs. Automating post-trade as much as possible is seen as a route to processing more trading volume without cost base increases.

How automated is the process of handling trade breaks within your organisation?



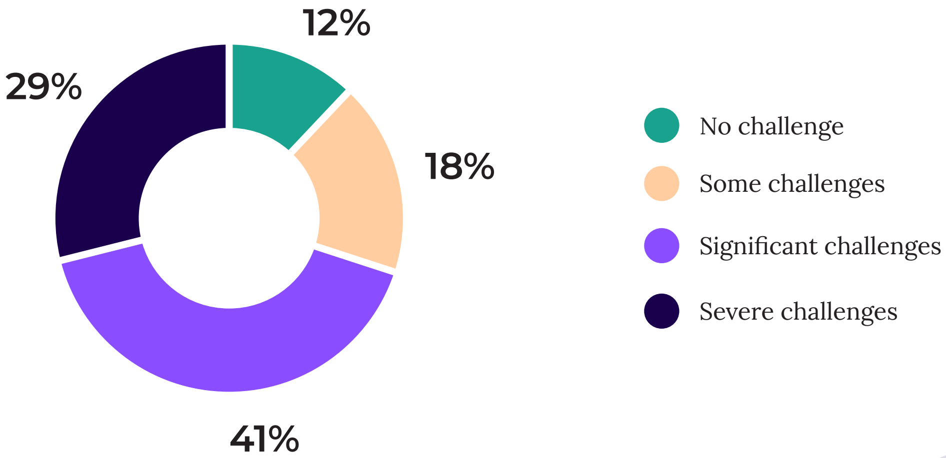
The desire for greater automation is not limited to post-trade, of course. Straight-through-processing is a desired goal for market participants in all asset classes. In listed derivatives, STP is relatively well-advanced, as shown by the fact over half of survey respondents reported relatively high levels of front-to-back efficiency.

How efficient is your front-to-back trade workflow in terms of STP from pre-trade risk to allocation?



However, for many the process remains inefficient. One of the key challenges firms have faced in building front-to-back STP is overcoming data inconsistency and in achieving full interoperability between internal systems. This was cited as a significant or severe challenge for almost three quarters of respondents.

Do you face challenges ensuring in data consistency and interoperability between internal systems?



Building operational resilience

Another key area of investment for front-office executives at FCMs today is in operational resilience. Incidents of cyber-attacks and outages have shown how exposed firms are both in their inhouse and third-party systems.

There is an inherent tension between investing in consolidation and efficiency and decreasing operational resilience through dependencies on fewer key systems.

While firms use several platforms for their OMS/EMS, these tend to focus on specific markets or products. Building a single back-up system to replace one or all of these platforms in the event of an outage, is for many firms both prohibitively costly and complex.

In interviews, firms reported that operational resilience with regards to systems was significantly more realistic in post-trade, where usually a single platform is used to process and settle trades. However, the cost of a full system back up was too high for many even here.

For many firms however, the necessity of having sufficient back-up systems will no longer be a choice.

The EU's Digital Operations Resilience Act will come into force next year and significantly increase FCMs' responsibilities when it comes to operational resilience.

Almost 40% of respondents to the survey said that DORA was now significantly influencing their decision making when it came to third-party EMS/OMS.

Conclusion

This report identifies four core themes from a market that is increasing investment budgets in the front-office in order to boost operational resilience and efficiency and meet the challenge of competition.

1. Competition is growing and likely to increase, technology will provide an edge

Competition has been intense for FCMs execution services. This has resulted in significant fee compression. With little left to cut in terms of fees, FCMs are seeking to differentiate themselves through customer service and value adds.

The new challengers to traditional FCMs include newly launched firms, some crypto native firms expanding into traditional markets, and others that started out with a focus on retail and are moving into institutional markets. In addition, FCMs face growing competition from non-bank liquidity providers who have already made significant inroads in ETFs and equities and are growing their offerings in listed markets.

Most of these new challengers operate advanced and recently built technology stacks. FCMs will be able to compete through advanced customer service and market knowledge but technology investment will be key to remaining competitive and enhancing their customer service.

2. Data fragmentation is hampering efforts to increase operational efficiency

The breadth and quality of third-party offerings is a major boost to FCMs. However, more than seven in 10 face significant challenges in managing data between platforms. This is hampering front-to-back efficiency but also preventing firms from achieving real-time risk and position management.

While most firms said that their levels of front-to-back efficiency was good, most still rely to some extent on manual processes for addressing trade breaks. If firms are to fully optimise trade workflows, data integration will need to improve.

3. FCMs are targeting platform consolidation

To reduce costs and streamline technology, almost half of FCMs are looking to consolidate OMS across asset classes. This will require upfront investment but will ultimately result in simplified operations and lower costs. The move to cross-asset OMS is being enabled by the increased sophistication of third-party offerings, but challenges still remain in widespread asset class consolidation. Most firms that were looking to consolidate were doing so only to a limited extent at this stage.

4. Operational resilience and DORA is requiring investment in back-up systems

While firms are looking to consolidate platforms, they are also facing a seemingly contradictory goal of investing in back-up systems both to assuage operational resilience concerns and to meet the requirements coming with DORA. DORA is already having a major influence on how firms approach OMS/EMS investment and this is likely to grow as the implementation date approaches in 2025.

Budget for regulatory requirements tends to come from other areas of the bank rather than the "run the bank" budget but FCMs should be allocating spend now to direct towards operational resilience and back-up systems.

acuiti management intelligence

+44 (0) 203 998 9190
acuiti.io
info@acuiti.io