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CAPITAL MARKETS

Trends in the Global Capital Markets Industry 2013: Financial Intermediary Firms

Key emerging trends across financial intermediary firms and their implications on the global capital markets industry

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1. Highlights

The global economy grew at 2.2% in 2013, a slow pace compared to the previous year's growth of 2.3%.[1] There were signs of recovery across the world: a shaky but notable improvement in the Eurozone; an aggressive shift away from deflation in Japan; stable growth in China; and growing momentum in the United States and the United Kingdom.

Improving outlook, stabilized valuations, and positive sentiment led to strong performance of equity markets worldwide, with significant gains witnessed in the developed markets. Global equity market capitalization grew by 17.0% during 2013 to $59.8 trillion.[2] Commodities continued to perform poorly due to disappointing growth in emerging markets, as well as reduction in the demand-supply gap.

The securities services industry is currently beset by tough economic conditions, thin margins due to commoditized services, and higher costs. Also, it is a specialized business that requires regular investments to keep pace with changing regulations and sophisticated products coming to market. While regulations present many challenges, they also offer opportunities. With fierce competition putting downward pressure on transaction and safekeeping fees, firms are implementing large-scale transformation projects (revenue enhancement, cost optimization, and value-added offerings) to remain viable.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) mandates the reporting of every swap transaction in order to increase transparency in swap markets and provide public disclosure of transactions. To meet this regulation, Swap Data Repository (SDR) is a new service that offers storage, retrieval, reporting, and maintenance features for trade data. This service reduces the regulatory burden for its clients by resolving duplicate entries, standardizing reference data, creating unique identifiers for every transaction, and maintaining a reliable database on a real-time basis.

1 Economic Intelligence Unit, March 2014
2 2013 WFE Market Highlights, World Federation of Exchanges, September 2013

2. Introduction

2.1. Global Capital Markets Players[3]

Global capital markets players can be broadly divided into three core categories:

- **Buy-Side Firms** – Mutual Funds, Hedge Funds, Pension Funds, Unit Trusts, Proprietary Trading Firms, and Private Equity
- **Sell-Side Firms** – Investment Banks, Brokerage Houses, and Independent Analysts
- **Financial Intermediary Firms** – Stock Exchanges, Clearing Houses, and Custodian Banks

This paper reviews and summarizes the key trends prevalent across financial intermediary firms and their implications on these firms and the global capital markets industry.

2.2. Global Capital Markets Performance

2013 turned out to be a year marked by improved global financial conditions and reduced systemic risk on the back of new policy initiatives by the government and central banks. These improvements helped in stabilizing consumer, business, and investor confidence.

Equity markets were given a significant boost in 2013 as the Federal Reserve committed to keep interest rates closer to zero, while announcing its decision to start tapering its quantitative easing program effective January 2014. Equity markets rallied in 2012 due to attractive valuations, tamed global inflation and accommodating monetary policies by many central banks, and broadening recovery.

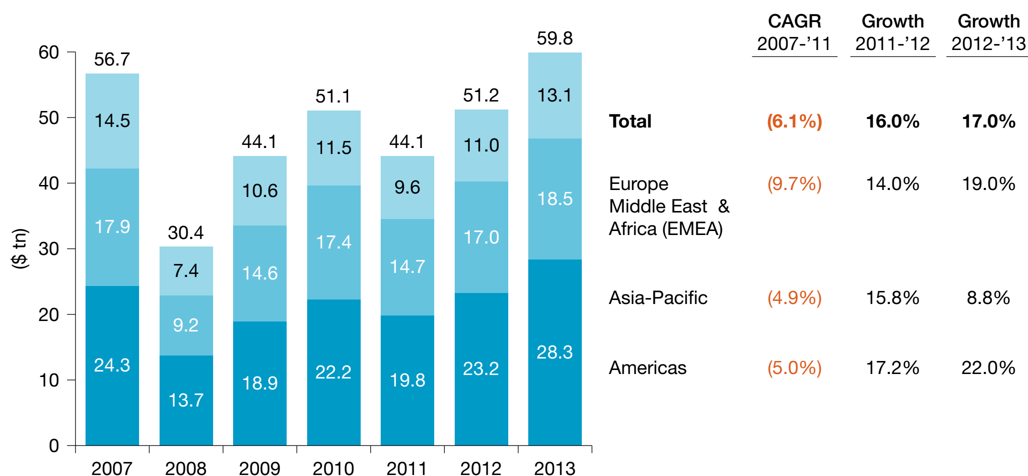
Global equity market capitalization grew by 17.0% in 2013 (January to December) to reach $59.8 trillion, beating the peak of $51.1 trillion attained in 2010 after the financial crisis of 2008.[4] The World Federation of Exchanges (WFE) also reported that the Americas region was the best-performing region, witnessing a growth of 22.0% in market capitalization to $28.3 trillion in 2013 (January to December). This increase was driven by improved investor sentiment, and the announcement of the tapering of quantitative easing by the Federal Reserve.

Europe, the Middle East, and Africa (EMEA) was the next best performing region in 2013, according to the WFE, with market capitalization growing by 19.0% to $13.1 trillion. European equity markets rose on account of lower valuations of European stocks compared to U.S. stocks, the control of inflation, and supportive monetary policies by central banks.

3 Wealth management and private banking are covered in a separate paper within our *What You Need to Know series*

4 World Federation of Exchanges

Exhibit 1: Global Equity Market Capitalization ($ trillion), 2007–13



	CAGR 2007-'11	Growth 2011-'12	Growth 2012-'13
Total	**(6.1%)**	**16.0%**	**17.0%**
Europe Middle East & Africa (EMEA)	(9.7%)	14.0%	19.0%
Asia-Pacific	(4.9%)	15.8%	8.8%
Americas	(5.0%)	17.2%	22.0%

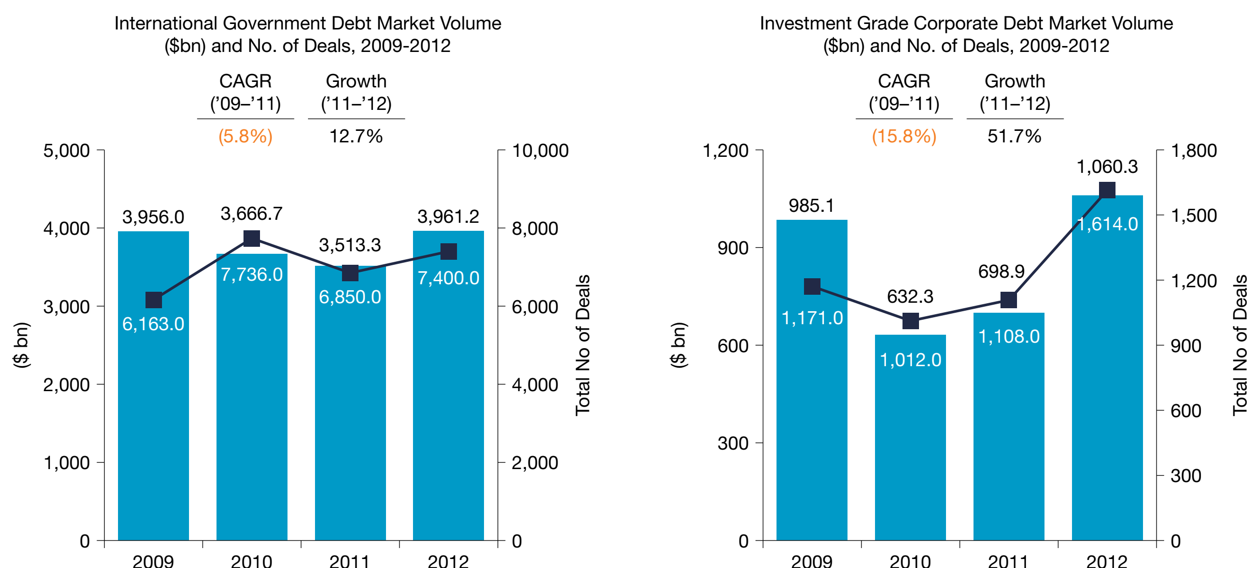
Source: World Federation of Exchanges, 2013

Asia-Pacific's equity market capitalization growth was the least among all regions in 2013 (January to December) according to the WFE, growing at 8.8% to $18.5 trillion, comparing with a higher growth of 15.8% witnessed in 2012. Performance of equity markets was particularly stronger in Japan and Taiwan with market capitalization increasing by ~30%. Market capitalization of the emerging economies of Indonesia and India fell due to higher inflation and current account deficit, political instability, and the tapering of stimulus by the Federal Reserve.

International debt market volumes grew by 12.7% to $3,961.2 billion from 2011 levels, primarily due to the lower interest rates prevailing across major economies.[5] Euro-denominated central government debt market volume rose by 26.4% to $107.8 billion from 2011 levels. International debt market volume and Euro-denominated central government debt market volume for the first nine months of 2013 stood at $3,054.3 billion and $149.9 billion, respectively, according to the International Capital Market Association (ICMA) Quarterly Report, Third Quarter 2013. In Europe, the European Central Bank's (ECB's) promise to buy back bonds of troubled nations in the event of a default, the objective of shoring up the banking system, and the intention to address the large budget deficits were some of the reasons for the increase in debt volumes.

5 International Capital Market Association: Market Data third quarter 2013, International Capital Market Association

Exhibit 2: International Debt and Investment Grade Corporate Debt, Market Volume ($ billion) and Number of Deals, 2009–2012



Source: ICMA Quarterly Report: Assessment of Market Practice and Regulatory Policy, Issue 30: Third Quarter 2013

The ICMA Third Quarter 2013 market data report also revealed that the volume of high-yield corporate bonds grew 28.7% during 2012 to $355.3 billion from 2011 levels and volumes of investment grade corporate bonds increased by 51.7% to $1,060 billion during the same period. International corporate high-yield debt volume and international investment grade corporate bond volume for the first nine months of 2013 stood at $322.4 billion and $812.4 billion, respectively, as per the ICMA report. With the availability of bank financing shrinking due to ongoing deleveraging efforts and tightened regulatory requirements, companies are tapping debt markets for their needs. Increased investor interest for higher yields in the light of a lower interest rate environment and stronger corporate balance sheets have also resulted in higher volumes.

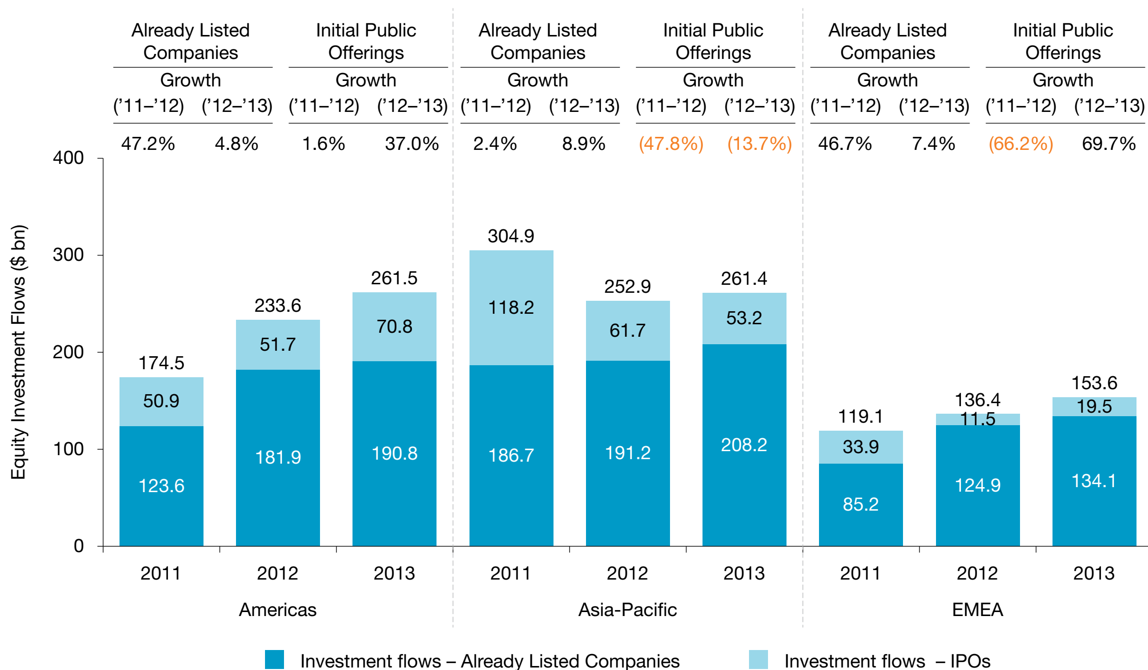
Commodity prices strengthened in early 2013 due to improved global economic outlook, but retreated later, going below 2012 levels due to improved supply conditions. Oil prices after hovering around $105 in Q1 2013 (marked by geopolitical tensions in the Middle East), dropped below $100 in Q2 2013 due to improvement in supply and easing of tension in the Euro region. Metals, which witnessed a price decline in 2012, continued their downfall in 2013 due to an increase in supply and the slowing down of the real estate sector in China. Compared to 2011, commodities fared better in 2012, but continued to struggle due to fluctuating demand from emerging economies.

3. Emerging Trends in Global Capital Markets – Financial Intermediary Firms

Total capital raised through Initial Public Offerings (IPOs) and follow-on offerings in 2013 stood at $676.5 billion, an increase of 8.6% from 2012 levels. The increase was primarily driven by increased appetite for growth companies, lower volatility levels, positive sentiment, and strong equity markets. Capital raising activity was particularly strong in EMEA with total capital raised increasing by 12.6% to $153.6 billion in 2013.

Total capital raised by American corporations on the primary and secondary markets increased by 11.9% to $261.5 billion, with follow-on offerings and IPO volume increasing by 1.6% and 37.0% to $190.8 billion and $70.8 billion, respectively. Strong growth in IPO volumes in the Americas could be attributed to reduction in volatility of the major indices and the rally in equity markets. In EMEA, while follow-on offerings volume increased by 7.4%, capital raised through IPOs grew by a solid 69.7%. The Asia-Pacific region was the hardest hit with total issuance volume rising by only 3.3%. IPO volume was particularly hit hard in Asia-Pacific, with issuance volume dropping by 13.7% from previous-year levels.

Exhibit 2: Equity Investment Flows ($bn), 2011–2013



Source: World Federation of Exchanges

The number of equity trades increased by 5.7% in 2013, with Europe registering strong growth, up 13.8% from previous-year levels. The Americas and Asia-Pacific witnessed a decline, with equity trade dropping by 7.8% and 3.2%, respectively. NYSE Euronext (U.S.) and NASDAQ OMX, which are major contributors to global volume of equity trades, registered a drop of 13.6% and 9.2%, respectively. Drop in equity trades in the Americas was also affected by Latin American exchanges, where volumes fell due to difficult economic conditions and negative equity returns.

Volume of bond trades rose by 15.8% in 2013 and this could probably have been driven by lower default rates on high-yielding bonds and investors' preference to take advantage of improved corporate balance sheets. Asia-Pacific witnessed the highest increase in the number of bond trades (up 41.2%). This strong increase in the bond trades could be due to lackluster performance of the majority of the leading equity markets in Asia-Pacific, which were negatively affected by tapering of stimulus by the Federal Reserve. Similarly, volume of bond trades in the Americas increased by 17.0% in 2013. On the other hand, EMEA witnessed a drop in number of bond trades, falling by 1.5% from 2012 levels.

Some of the key emerging trends observed in the financial intermediary industry included[6]:

1. Increased implementation of transformation programs by post-trade market infrastructure providers
2. Emergence of Swap Data Repositories to improve transparency

Note that several trends covered in the 2012 Trends in Capital Markets Series are still relevant and not explained again in this paper. These include:

1. Exponential growth in data output intensity
2. Increased importance of Swap Execution Facilities (SEFs) in derivatives trading
3. Rise of global alliances
4. Continued focus on technology infrastructure upgrade

6 Trends shown are not necessarily comprehensive, but have been highlighted due to their relevance and potential impact on the industry

4. Trend 1: Increasing Focus on Transformation Programs and Collaboration by Post-Trade Market Infrastructure Providers

4.1. Background and Key Drivers

Global post-trade infrastructure service providers hold trillions of dollars of assets under custody, as well as clear and settle trillions of dollars' worth of transactions. Over time, these service providers have evolved to play a critical role in securities markets, making them ideal partners for clients that want to operate across global capital markets. Post-trade infrastructure firms have moved on from mere custody of assets to providing value-added services to firms including collateral transformation and management of the middle-office function of investment managers.

However, the global financial crisis of 2008 had a damaging effect on the functioning of these players. Many of the post-trade service providers are currently dealing with the aftermath effects of the financial crisis, which resulted in a wave of regulations, lower margins, a rise in cost-income ratio, and increased demand for operational transparency. As a result, firms are implementing transformational programs and entering into strategic collaborations to enhance revenue and gain efficiencies.

The key drivers for implementation of transformation programs and increased collaboration among post-trade infrastructure providers are:

- The global financial crisis led to a dramatic drop in securities lending activity and resulted in near-zero interest rates in the developed economies around the world. This resulted in stress on the existing revenue models of post-trade infrastructure providers.
- Financial intermediary firms are witnessing an increase in cost- income ratio, mainly due to increased compliance costs as a result of new regulations in the capital markets industry, which are aimed at reducing the systemic and counterparty risk.
- With the ECB aiming to harmonize Europe's settlement system, one section of the custodians are likely to face a threat from Central Securities Depositaries due to commoditization and the ensuing cannibalized margins. The ECB launched the T2S (Target2Securities), which aims to integrate and harmonize the current highly fragmented securities settlement infrastructure in Europe.

4.2. Analysis

Post-trade service firms are witnessing increased pressure on revenue and margins due to the reduction in trading volumes and drop in securities lending activity. Increased demand for transparency of daily operations in terms of new reporting requirements (mandated by a series of regulations) has resulted in an increase in regulatory and compliance costs, forcing consolidation in the already concentrated industry. Some of the recent deals in the post-trade space include the purchase of ING's Central and Eastern Europe custodian operations by Citi[7] and Standard Chartered's acquisition of Absa Group's custody and trustee business.[8]

Pressure to generate revenue and rising costs have forced firms to look for efficiencies in operational aspects of business. To compete effectively in a difficult economic climate, firms are also implementing huge transformation programs for operational excellence. For example, State Street launched its transformation program (business operations and technology) in 2010 and plans to achieve annual pre-tax run-rate expense savings of $575 million to $625 million by the end of 2014.[9]

Apart from the cyclical factors, structural changes in the form of regulations are also driving firms to implement transformation programs and enter into strategic partnerships to offset the decline in revenue from traditional sources of safekeeping of assets. Regulations that are having an impact on securities services players include the Dodd-Frank Act, European Market Infrastructure Regulation (EMIR), and T2S. The new regulations under Dodd-Frank and EMIR require over-the-counter derivatives to be cleared by central clearing counterparties and also the posting of high-quality collateral. Post-trade services firms are viewing this as an opportunity and players like Bank of New York (BNY) Mellon, Northern Trust, and J.P.Morgan are offering collateral transformation and optimization programs to their clients where non-eligible types of collateral can be switched for high-quality assets/securities.[10]

In order to address the collateral crunch, post-trade infrastructure providers are also launching liquidity alliances/entering into partnerships, which will enable common clients (of partners) to pool and mobilize their domestic and ICSD (International Central Securities depositary) assets and thereby optimize the allocation of collateral. For example, ASX (Australia), Cetip (Brazil), Clearstream (Frankfurt/Luxembourg), Iberclear (Spain) and Strate (South Africa) have launched a liquidity alliance, which will enable their clients to offer collateral in a particular country through assets held in other countries/currencies. Likewise, Euroclear and Citi have entered into collaborations for collateral management, which makes available the assets at Citi's custodian network as collateral when Euroclear acts as the tri-party agent. These sorts of partnerships increase efficiencies and transparency, and reduce settlement risk for all the participants.

7 "ING to sell custody services in 7 European countries to Citi, Reuters", April 26, 2013

8 "Standard Chartered to buy Absa's South African custody business", Reuters, April 18, 2013

9 "Update of the business operations and information technology transformation program", State Street, October 18, 2011

10 "Wall Street's latest idea", *Financial Times*, March 4, 2013

4.3. Implications

The changing dynamics of post-market infrastructure, due to excess competition and regulations, is forcing firms to embrace business models that would enable them to remain competitive and viable. Thus, firms need to invest in transformation programs to keep pace with the changing regulatory landscape and create efficiencies. Post-trade service firms may look to achieve these operational efficiencies through operational and IT transformation process. Firms need to focus on automation and standardization, establishment of centers of excellence, leveraging low-cost locations, and optimization of cloud technology to drive savings.

On the technology transformation front, firms that have multiple technology platforms in multiple geographies or legacy systems due to acquisitions, can integrate their platforms in order to ensure that technology spend is not spread across various platforms. For example, BNY Mellon as part of its technology transformation initiative is consolidating its current three custody and four transfer agency platforms to two.

On the operational excellence front, firms can leverage low-cost locations across the globe by establishing global delivery centers. For example, BNY Mellon launched a new global delivery center in Poland to optimize its infrastructure and support its global business plans. Post-trade service firms can also initiate process re-engineering across the organization to improve workflows and increase quality.

5. Trend 2: Emergence of Swap Data Repositories to Improve Transparency

5.1. Background and Key Drivers

Traditionally, swaps were traded over the counter (OTC) between counterparties. A financial institution could offer a swap for one price, while another institution might sell the same swap for another price. This left market participants uncertain of a standard price. In order to change this, the Dodd-Frank Act created SDRs to promote market transparency and price discovery. Under this act, both cleared and uncleared swaps must be reported to registered SDRs.

SDRs are responsible for collation of records of OTC derivatives and acts as a central repository for swap data reporting and recordkeeping. Any entity that wants to perform the functions of a SDR needs to be registered with the Commodity Futures Trading Commission[11] (CFTC).

Once registered with the CFTC, an SDR must fulfill the following requirements:

- Submit an annual amendment on Form SDR not more than 60 days after the end of the registered SDR's fiscal year
- Submit an annual compliance report to the CFTC within 60 days of the end of the registered SDR's fiscal year
- Submit financial statements to the CFTC on a quarterly basis

Reporting of swap transaction data on interest rates and credit derivatives started from December 31, 2012. Effective February 28, 2013, swaps on equity, foreign exchange, and commodity swaps are being reported. The reporting of remaining swaps began in October 2013.

The basic essence under which SDRs operate is to promote transparency to the swaps market, provide real-time disclosure of information, and maintain policy and procedure as per regulations to ensure data integrity and security.

5.2. Analysis

Financial intermediary firms associated with swap dealing, clearing, or execution services, are facing the burden to manage the new reporting requirements arising from new regulations such as Dodd-Frank. In order to implement these requirements, firms need to make the following changes:

- Changes in front -to-back information technology – Request for Quote , Order Management, and Order Book systems are being modified to meet the swap data reporting rules
- Changes are being made to operations, trading desks, finance, and risk management to support the tracking and reporting of swap data
- Day-to-day testing and compliance processes are being implemented to identify and rectify erroneous reports

11 CFTC is an independent agency of the United States that regulates futures and options markets

On June 28, 2012, Intercontinental Exchange (ICE) Trade Vault gained CFTC approval for creating the first SDR under the Dodd-Frank Act. ICE Trade Vault operates a SDR for the interest rate, credit, foreign-exchange and other commodity asset classes. This SDR service has reduced the compliance cost for its customers by leveraging its network of trading exchanges and clearing houses. It provides standardized information, resolves duplicate entries, and allows multiple parties to query databases in real-time. It also creates unique swap identifiers for every transaction, which helps to record, retrieve, report, and maintain data. In this way, ICE provides a robust and simple solution for SDR.

In April 2013, post-trade services company Traiana introduced its SDR service, Harmony TR Connect, to comply with reporting requirements under Dodd-Frank legislation and the EU's European Market Infrastructure Regulation. Harmony TR Connect offers a single point of contact between market participants and trade repositories.

In May 2013, Clarus Financial Technology introduced SDRView, which provides key metrics of trading activity for a day, a week, or a month. SDRView makes use of dashboards, charts and grids to provide intra-day updates and further drill-down capacity. SDRView helps market participants to extract value from the vast dataset collected by SDR.

Such initiatives by market participants will help in the compliance with SDR regulations.

5.3. Implications

This new SDR requirement has increased the IT spending of financial intermediary firms on the upgrading of their existing systems. Firms need to conduct a gap analysis to assess the difference between existing capabilities and the new reporting requirements. The increased number of SDRs and other market participants will require central clearing, monitoring, reporting, and complex daily reconciliations. Daily valuation of uncleared trades will become an additional requirement. Regulators are expected to intensify reporting on trade, position, and risk. The file record for all OTC derivatives transactions will be maintained for a certain period post-trade termination.

The new SDR requirement will affect all market participants of OTC markets either directly or indirectly. Large market participants will face increased margin requirements. Speculative traders will be required to centrally clear trades and also fulfill complex margin and collateral management. Higher margin and collateral requirements might lead to lesser dependence of buy-side firms on the derivatives market.

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