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Facing sell-side challenges with data analytics

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Regulation is rapidly increasing transparency across financial markets, enhancing audit requirements and ensuring effective market surveillance. However, the mounting cost of compliance continues to squeeze sell-side banks, which have been facing declining FICC revenues and higher capital costs. With the introduction of MiFID II set for January 2017, technology, and particularly data analytics, could hold the key to developing competitive advantage in this new regulatory reality.

Declining FICC revenues and measuring the impact of regulation

Since the financial crisis in 2008, regulation has played a key role in transforming the structure of capital markets and the manner of counterparty interaction. The requirements imposed have enabled regulatory bodies, such as the FCA, FINRA and SEC, to introduce more effective monitoring and superior levels of transparency across foreign exchange (FX), fixed income, equities and commodity markets.

Driven by regulatory change, trading activity has migrated away from opaque voice based markets towards a model based on transparency and risk mitigation on electronic venues, with market participants increasingly required to report and clear trades through CCPs.

The playing field for sell-side sales & trading teams is shifting permanently from relationship driven to electronic message based banking.

However, whilst the structural benefits of reform to the financial ecosystem are wholly apparent, the cost of compliance for individual firms has increased significantly, with sell-side banks bearing the lion's share of the burden. As a result, the ability of these institutions to hold trading inventory and operate as liquidity providers has been increasingly constrained by regulatory capital requirements and mounting pressures on fixed costs.

According to the Economist, FICC revenues have fallen by 48% among the world's largest banks over a four-year period between 2009 and 2013 and the downward trajectory is expected to continue.[1] This has much to do with the desire from the Central Bank community to keep long terms interest rates low through quantitative easing thus depressing trading activity but also the weight of regulation. Current industry research indicates that these sell-side institutions will continue to experience fixed income balance sheet declines of between 10-15% over the next 2 years and as much as 15-25% out of flow rates.[2]

Facing the challenge

- Banks' FICC revenues have already declined by 48%
- Cost-to-income ratio (CIR) remains above 70%[3]
- Fixed income balance sheets set to decline by further 10-15%

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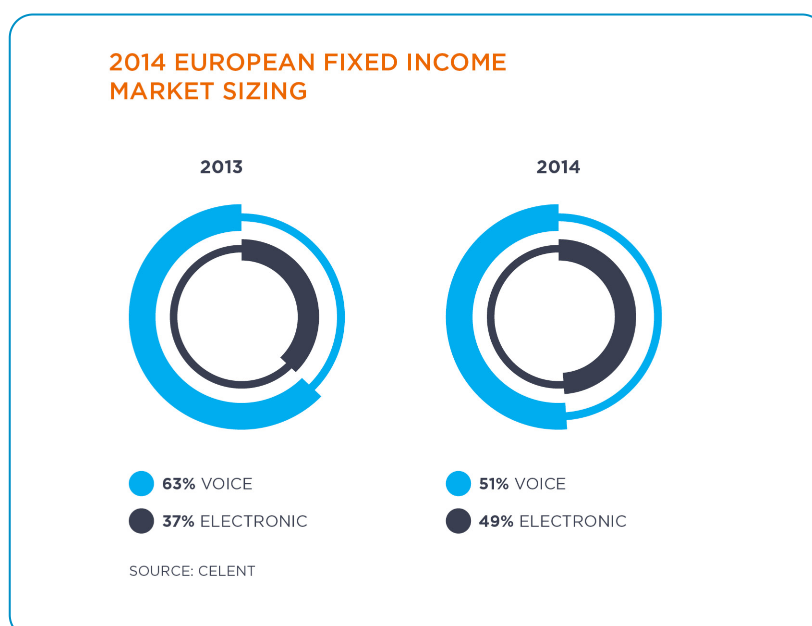
[1] *The Economist: The Engine of Investment Banking is Sputtering, April 19th, 2014*
[2] *Oliver Wymann: Wholesale & Investment Banking Outlook 2014*
[3] *Boston Consultancy Group, Adapting to Digital Advances, Global Capital Markets 2015*

These challenges have arisen as a result of two prominent factors; (i) a sharp rise in regulatory oversight, with banks now having to post increased regulatory capital to cover potential losses and (ii) tighter spreads associated with electronic trading, having a detrimental impact on revenue. While this provides enormous benefits for the wider market, this decline in margins has resulted in banks having to turn over their balance sheets at a faster rate, as the cost of warehousing risk has becomes increasingly prohibitive.

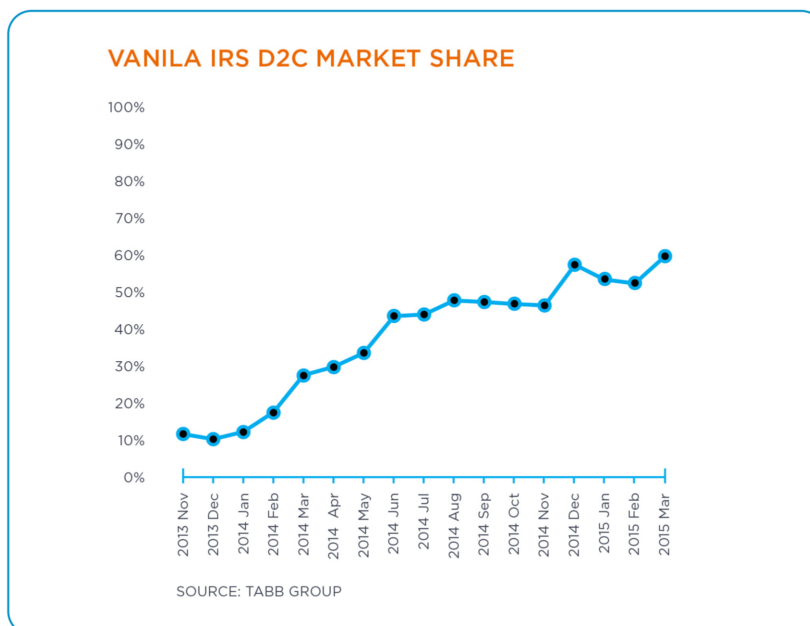
Adding to the current concerns, the implementation of MiFID II will further reshape the regulatory landscape, posing new challenges for banks, but more specifically by changing the way in which bonds, derivatives and ETFs are traded on electronic platforms. Whilst full details are yet to be finalised, proof of best execution is a regulatory certainty and the new rules will force players to adjust their market models towards a hybrid-agency model. This will be especially relevant for banks that cannot afford the capital costs of maintaining inventory. Clearly many of the lessons learned from the equity markets will now be applicable to the FICC markets, with specific emphasis on being able to measure execution performance (TCA) in both a principal and agency environment.

Marching out of Step

Despite the growth, adoption rates in electronic trading, a key component of financial technology remains inconsistent, with significant discrepancies between FX, equities and fixed income, as well as across geographical lines. The fixed income market, for example, has transitioned at a slower pace by comparison, with 57% of volume executed electronically in Europe and only 12% in the US in 2014, according to Greenwich Associates. However, sell-side fixed income volume executed electronically continues to increase, as data from Celent demonstrates.



Observing the US IRS market in the chart below, which has been directly impacted by Dodd-Frank, it is apparent that the migration to electronic venues can be relatively immediate. In the dealer-to-client market, SEF (electronic) market share rose from ~10% in Jan 2014 to the current ~60% (March 2015) with further electonification anticipated. The implication for European markets with the upcoming MiFID II implementation in January 2017 is apparent.



Old heads. Young minds.

Although a cliché, every cloud has a silver lining, and this could well be the case for FICC markets. The financial crisis and subsequent regulation proved to be extremely important in ushering in the current wave of creativity and fintech innovation, causing banks and other financial institutions to rethink their strategies. Many are coming to the realization that they need to partner with emerging innovators. As such, finance and technology has become synonymous, and data analytics, in particular, is moving to the forefront of efforts to provide new solutions to on-going market challenges, such as trade reporting, risk management and audit requirements. Moreover, a profound and atomic understanding of client activity and behaviour will define winners and losers in the coming years.

With technology front and centre of today's financial marketplace, the debate remains as to how to effectively identify and deploy new technology, leading to the perennial question of: *Should we build in-house or purchase from a specialist vendor?*

Building in-house solutions has its benefits, but takes significant time and resources. With budgets and margins under real pressure, many firms are unable to meet this challenge by deploying internal teams to address the overwhelming tidal wave of change. By opting for the latter, banks have been able to cut their time to market by years, quickly and efficiently adhering to new market rules and meeting best practice legislation.

Another significant advantage for banks in outsourcing technology to third party providers is to keep pace and engage with the rapidly evolving fintech landscape. As a result, they are now looking to technology vendors to bridge the gap and ensure sales & trading teams have access to the best and most competitive tools.

By tapping into fintech clusters like London and New York, banks are capitalising on the highly focused and outcome-based delivery of these companies. As a consequence, it is not surprising that global investment in financial technology ventures has more than tripled, from less than US$930 million in 2008, to more than US$2.97 billion in 2013.[4]

Smart data is the new currency

Within the fintech sector, the field of data analytics has quickly become the new opportunity in financial markets. This comes at a time when banks are beginning to recognise the competitive advantage that can be gained from partnering with specialist technology vendors.

However, challenges persist. Whilst electronic trading has generated a torrent of transaction data, the industry currently lacks the necessary processing tools for effective aggregation, standardisation and analysis. This has become crucially important to sell-side firms at a time when strategy differentiation by market, client type or geographical region is becoming common practice as a means to achieve unique competitive advantage.

Furthermore, market fragmentation, as a result of the proliferation of electronic venues, has effectively fractured liquidity and trading volumes in some markets, rendering the standardisation of trade data more challenging.

Only by gaining control of an abundance of available data and deriving actionable intelligence will banks be able to focus on identifying new opportunities and generate the highest returns in the markets they choose to compete in and be able to navigate the new regulations and operational challenges ahead.

The pace of change in the field of data analytics is rapid. As technology vendors continue to work towards providing easy-to-use tools that can be quickly integrated into existing systems, it is the ability to harness predictive analytics based on historical patterns that remains at the cutting edge. For a FICC-trading bank, this could provide answers to questions such as: Which clients am I anticipating seeing in the market today? Or, what products do I think clients will likely be trading?

The business advantages that can be harnessed by predictive analytics are significant and will act as a differentiating factor in performance. In a recent Harvard Business School article, leading academic and analytics guru Thomas Davenport argued that we are now entering the era of Analytics 3.0, where its predecessors were Business Intelligence (1.0) and Big Data (2.0). It has been predicted that by 2017, firms with predictive analytics in place will be 20% more profitable than those without.[5]

As the FICC trading ecosystem continues to evolve, sell-side institutions must focus on how to apply technology at the intersection of trading, regulatory compliance and operational efficiency to maintain and grow market share within a profitable client universe. The entrepreneurship and financial creativity of yesteryear, which is being restricted by regulatory codes of conduct led by global government agencies, can only be replaced by the granularity of understanding that intelligent data analytics delivers.

In what has become a challenging environment for all, the real question is how quickly the industry can adapt.

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[4] *Accenture, The Future of Fintech and Banking, 2014*
[5] *Gartner 2015*

About the Author

As Founder and CEO of Mosaic Smart Data, Matthew has brought together a team with a wealth of experience in FICC markets, technology and data analytics to address a number of challenges facing sell-side institutions in the fixed income market. During his time as Managing Director and Global Head of Rates & Credit e-Commerce Platforms at Deutsche Bank, he identified the need to harness the vast quantities of data available to banks and translate it into actionable business intelligence. Mosaic's MSX™ platform is based on aggregation, analytics and prediction with the objective of boosting sell-side productivity, meeting the desire for improved ROI and driving the right business decisions in a sea of overwhelming complexity.