***Julia*:** **Hello and welcome to a DerivSource podcast. I'm Julia Schieffer, the Founder and Editor of DerivSource.com.**

The past two years has seen several futures commission merchants or FCMs withdraw from the clearing space due to tighter regulation and higher costs. Non-FCMs are taking up the slack but questions remain over whether they can fill the gap and if the trend undermines the development of the OTC derivatives market. In this DerivSource podcast we speak to Gerry Turner of Object Trading who discusses the changing FCM model, the new players and the evolving OTC derivatives market.

Here is, DerivSource reporter, Lynn Strongin Dodds, speaking to Gerry Turner.

Lynn: **Hi, I'm Lynn Strongin Dodds, reporting for DerivSource. We have Gerry Turner, Managing Director of Object Trading, who's going to talk to us about the future of the FCM.**

First question is: over the past two years, State Street, BNY Mellon, Royal Bank of Scotland and more recently Nomura have closed their OTC clearing units, what have been the drivers and what do you see for the future?

Gerry: I think the drivers are pretty clear, and there's two or three of them, but I'll focus on two. The first is the cost of capital and just the expense of running these businesses now with the new regulations that have come in. So, firms have got to look at the business to see how their business model now works out, and if you take Nomura as the example now, I believe they're withdrawn from the North American and European businesses, they weren't the world's biggest players there, I think and believe from reading the articles, but they are still very, very large in the Asian region, their home region, and there they intend to continue in their business.

So the first one is cost of capital and the effect of the regulations coming through, I think it's MiFID II and the effect on the core capital ratios that banks have to hold.

The second is just regulation as a whole, and the business is changing, we know it's changing, going to the centrally cleared OTC model. What does that mean for the more traditional OTC market which was bilaterally cleared etc, so the model itself is fundamentally changing.

***Lynn*:** **You talked about the business model changing, perhaps you can give us some detail on what specific changes, and what type of services do FCMs need to provide to remain competitive?**

Gerry: So, we're looking at bank FCMs in particular, and there's a lot of focus on those guys at the moment. Bank FCMs are still in the market and I think talk of their demise is very much overdone at the moment. FCMs play a very, very important part in the market because they do more services than just the futures clearing. If you look at a bank and they provide other services to the buy side, and to the market participants with respect to capital, funding, securities lending, and those associated services where typically smaller brokerage houses, more specialised firms don't have the breadth of facilities. That's number one.

Number two, is FCMs, when they're operating globally, have the ability to hit a large number of venues around the world, and to give the ease of having one relationship that can facilitate many geographies, and asset classes of trading. Again, the more regional firms struggle sometimes with those pieces.

Also, if we look at non-bank FCMs, these guys also need services for markets that aren't maybe their core markets and they need assistance and carry brokers for maybe different regions or different product asset classes.

The FCMs as well, typically, will also be in the OTC derivatives market as well, so the changes in the OTC and the competition or the struggle between the futures market and the OTC market, the FCMs are typically are in both sides of that trend.

***Lynn*: In terms of the market itself changing, do you think there has been a lot of trends towards swaps futures and people predicting that's going to happen. It hasn't happened yet; do you think that's the future way forward?**

Gerry: I've had several conversations with people who trade in these markets. If you took it from the OTC world, the kind of standardisation of the OTC swap markets is moving more towards the way the futures markets behave; the standardisation way of the contracts.

If you look at the futures market, they're trying to find a way of servicing the bespoke and more flexible approach of an OTC, the old typical OTC market where it was tailored for specific requirements.

And you see both sides of that trying to come towards middle ground. Futures, central order books, most OTC is an RFQ basis. There are two fundamental ways of trading here, and I've spoken to both sides, just interestingly, and the motivation from the OTC guys to go to Futures is not quite there yet. We're going to be centrally cleared and that's a big step forward in the OTC market from the regulators' point of view. But there's no actual driver to go on exchange; they're happy in the way the market has been trading and behaves.

You talk to the Futures folk who are looking to OTC markets, they are quite happy because they know the way the futures market behaves; there's a central order book, the way the price transparency is there, and they have little motivation to go the opposite direction.

If you ask me who's going to be the winner out of that, I think we're going to end up with a hybrid of both models there, at least for the foreseeable future.

***Lynn:* In terms of the FCMs, who do you think will be the most successful? Does the current environment spell the end of the universal model and does it mean the rise of the local, specialised FCMs?**

Gerry: To answer your question on the universal model: absolutely not. I think the universal model is there to service a requirement of the market, it may be not the size it is today; it may contract, but it's absolutely still essential. Having the view I do of several large institutions, they view it that way as well, and I know one that still has a very strong retail business, believe it or not, in the futures industry, and that services the need of the end customer. While that's still there, and I believe it will be there for a time going forward, somebody has to service it, so the universal model is absolutely still valid in my book.

However, the market, I think is driving into different levels of strata - maybe look at it that way. The global banks and FCMs, and those with that sort of reach, and other facilities are beginning to service a very distinct customer base out there: the larger funds, the hedge funds, the larger businesses themselves, and they are looking very actively at their accounts list, and there are well known and well documented reports that these firms are off boarding clients that don't meet the new criteria that they are looking for, be it account size or trading volumes, revenues, etc.

Those firms that find themselves in that situation on the buy side, these buy-side firms still need to do business. The market is here to serve a purpose, and those guys need to do business, be it for whatever, hedging etc, the usual reasons for trading the markets, and they need to be serviced somewhere. That's been the rise of the more regional and more specialised brokers have been very, very active in being able to service that market themselves, and those buy sides.

There is a reciprocal part to that as well, which is the regional brokers and futures brokers, they need facilities as I mentioned before, and the larger FCMs do provide those as well, so it's not all moving from one place to another, there's a leveling out of the field, and firms deciding what they're good at and what they can do efficiently, and a segment of the market that they can service, and doing that very, very well.

***Lynn*: Following on from that question, do you think it's across Europe, or are there particular countries in Europe where you're seeing that trend? So is it mainly in the UK because of the derivatives industry, or is it in Germany or France?**

Gerry: My view, in Europe at least, is very London-centric. Based in London, we have the view from London outwards. I would say I'm seeing the same effect in Germany, there's a lot of regulation from BaFin in Germany which has been a prompt for firms to look at businesses over there and to reevaluate and maybe carry on doing what they're doing, or maybe changing tack slightly. But my specific view has been from London, and looking over towards the US as well.

The US are ahead of us, ahead of Europe, ahead of regulation and the way it's coming forward and being implemented, and Europe's not far behind that. I guess the question after that is: that's one half of the world, what's the other half of the world going to be doing as far as regulation, how the market's going to develop over there.

***Lynn:* What impact does the retreat of the FCMs have on the business? Could it seriously undermine the evolution of OTC clearing?**

Gerry: I'm not sure it's going to undermine the evolution of OTC clearing. I think OTC clearing is going to happen. I contend the retreat of the FCM is not actually a retreat; it's a change of who's servicing different segments of the market, as I described before. We have to remember, and bear in mind, that the market is not self-serving; it's there to serve a purpose, and that purpose is still there.

Firms still have to hedge positions and run their businesses with financial prudence, and commodities still need to be…crops still need to be grown and sold in the future etc, so there is always a business to be done there.

There is, however, a concern out in the wider world that the cost of doing business nowadays; the cost of trading, the cost of clearing, the cost of capital, is changing the hedging equation slightly. So, if I want to cover a position, I'm a farmer, I'm growing crops, but it costs me so much to hedge, or to get locked in at price in the future, I may not take that anymore, in which case I'm driving in some risk into the real world where I'm sure that was never intended.

So my concern is less about the retreat of the FCM, it's maybe some of the buy sides being disenfranchised and actually being driven out of the market because either they can't find anybody to service their requirements, or just the cost of doing business means that the risk weight equation is no longer there.

***Lynn:* Given the retreat, do you see filling the gaps left by FCMs, or do you see FCMs coming in to the market?**

Gerry: Absolutely. Yes.

Non-bank FCMs are being very good at servicing requirements, be it down one asset class or a group of asset classes, or they're services a particular geography. We're seeing that with the recent move of RJ O'Brien over into Europe and the UK in a bigger way with their purchase of Kyte, shows that there is ambition there by these firms.

We're seeing in the market; they are definitely, definitely servicing client base that the larger FCMs can no longer do efficiently.

***Lynn*: Do you think they'll go after those smaller clients and be competitive with the regionals?**

Gerry: Yes. Absolutely. And I think that's a fact in the market, and it's not a hidden fact either. As I've said before, clients need to be serviced, and if they can't be by the larger firms, then the more regional, specialised firms will absolutely go there. We know that, we can see that.

I think there is another layer, however. There is another segment of the market where even the regional FCMs can't service them properly, and that may be because again their style in the market is not something they support or breadth of markets they've got to cover, the regionals can't do. I had a recent example where a regional broker who's very good at Europe was servicing a client, and then the client wants to move into another region, North America, and they didn't have their own personal reach there, and so that buy-side client has to find another broker which becomes less efficient with capital. Today, capital is king, we know that.

***Lynn*: The final question is really about the challenges these non-FCMs face as well as what type of non-bank FCM do you see entering the market? You mentioned RJ O'Brien, but are there any other type of firms you see coming in to this market in the future?**

Gerry: I see the firms have been typically smaller and very specialised in the market, especially around geographies. They've been quite ambitious recently in upping their businesses and there's been a lot of hiring in firms out there.

The challenges they face are the usual ones. Scaling, so how big can they get? The challenges of how are they going to do these complementary services which were previously provided by banks; the funding, securities lending, all those sort of pieces there which have always historically been done in one place, and that's part of the prime services deal. And then what happens when they go out of their comfort zone? What happens when customers say to them, "You're great at this asset class, but I want to do that asset class", how are they going to service that, and can they? And if they can't, then what does that mean to the market?

***Lynn:* I know you didn't mention the firm, but what type of sector…is it mostly custodians or third party vendors, or… What type of non-bank, in terms of category?**

Gerry: The smaller brokers. It's smaller brokers that are growing, and I think one latent out there which hasn't really developed, that I can see, as yet, and possibly will be, is taking the interdealer broker market, the larger interdealer market, and are they going to move in to that?

Historically, they've not been the greatest players in the futures market, but they're probably in a very good position to do so. So it will be very interesting to see what they do over the coming months and years.

Julia: Thank you for listening to this DerivSource podcast.

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