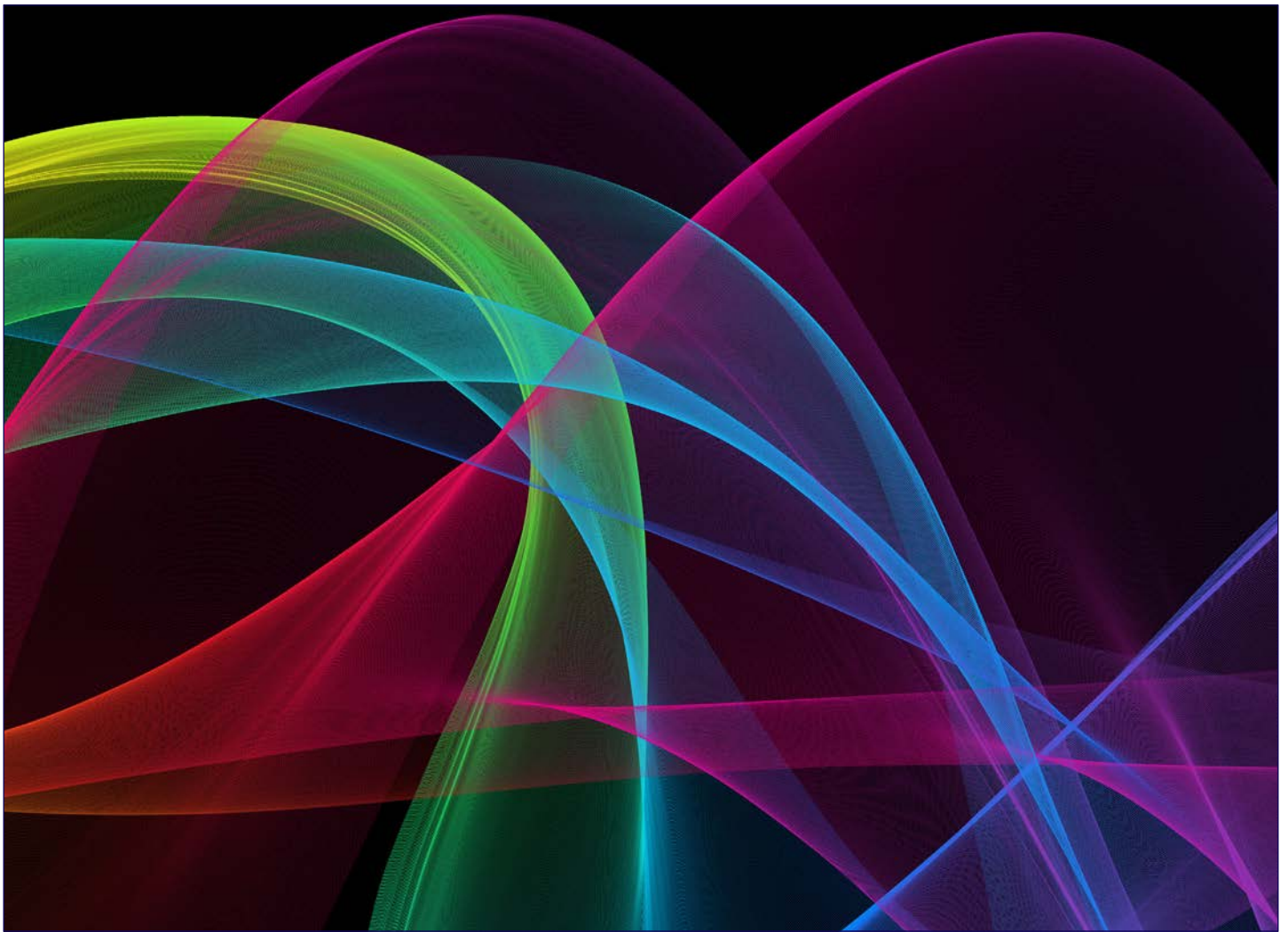


The changing shape of buy-side derivatives strategy

Risk.net May 2021

Survey report & white paper



This survey report explores the changing needs and priorities, and the evolving strategies of buy-side firms in managing derivatives portfolios, liquidity and collateral

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EUREX

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About Eurex

Eurex stands for the leading European derivatives exchange and – with Eurex Clearing – is one of the leading global central counterparties (CCPs). Eurex is the architect of market liquidity, efficiency and integrity by providing customers with innovative solutions to seamlessly manage risk.

On the trading side, Eurex masterminds the most efficient derivatives landscape by pioneering ingenious products and infrastructures, and building ‘smart’ into technology – offering a broad range of international benchmark products, operating the most liquid fixed income markets in the world and featuring open and low-cost electronic access.

As a CCP, Eurex Clearing builds trusted relationships with and among market participants, paving their way to efficient risk management via unique clearing models.

More information about our fixed income, funding and financing offer at www.eurex.com/fiff

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Executive summary

In the wake of the Covid-19 pandemic-related turmoil of 2020, as well as Brexit-related upheaval and ongoing regulatory change, recent research reveals buy-side firms are rethinking liquidity and collateral management strategies. According to the results of a market survey conducted in the first quarter of 2021 by *Risk.net* in conjunction with Eurex, the events of the previous year have prompted buy-side organisations to reassess the priorities for their derivatives portfolios. With volatility an ongoing concern, these firms are moving to future-proof their portfolios and create more efficient systems and processes for collateral and liquidity management to protect against further turbulence.

The aim of the survey was to discover how buy-side organisations have changed their derivatives strategies and collateral and liquidity management over the past year, as well as the outlook for such strategies over the next two years.

The survey measured the impact of six key recent events or market developments: Covid-19, Brexit, uncleared margin rules (UMR), best execution requirements, pension clearing exemptions under the European Market Infrastructure Regulation (Emir) and mandatory haircuts on securities finance. The key questions answered by the survey were:

- Which of these measures have had the greatest impact on the buy side from a derivatives, liquidity and collateral management perspective?
- What implications have they had for recent and future strategies in relation to derivatives trading as well as collateral and liquidity management?

A total of 89 respondents participated in the survey during January and February 2021. These respondents came from buy-side organisations including asset managers, hedge funds, insurance companies and pension funds (see *About the survey*, page 10).

Key findings

- With respect to their derivatives strategies, the Covid-19 pandemic and Brexit had a more significant impact on buy-side organisations in Europe, the US and the UK than specific market issues such as best execution, uncleared margin rules and European Market Infrastructure Regulation pension clearing exemptions.
- Market volatility over the past 12 months, due to issues including Covid, Brexit and regulatory change, has prompted buy-side firms to work on processes and efficiency to improve liquidity and collateral management over the next two years.
- Buy-side firms also plan to prioritise collateral and margin management and optimisation capabilities, and work on changing more business from bilateral to central counterparty (CCP)-cleared derivatives over this time period.
- The survey revealed a widespread appetite among buy-side entities to adopt a centrally cleared direct or sponsored buy-side access model for various types of transactions.
- Buy-side respondents strongly agree that direct access to clearing can improve execution terms and counterparty risk management.
- While concerns remain around legal complexity and operational requirements such as margin calls, a majority of buy-side firms see clear benefits in moving to a sponsored or direct model for CCP-cleared derivative or repo transactions.

Percentages in some tables and graphs may not total 100 due to rounding

Introduction – Assessing the impact

As the global financial markets emerge from the darkest days of the Covid-19 pandemic, most organisations are taking stock of the events of the past year and applying lessons learned to their businesses. Many organisations in the sector have also had to deal with the implications of the UK's secession from the European Union playing out over the course of last year, an event still being resolved post-Brexit.

Running alongside these major one-off events, buy-side firms must also address an increasingly complex world of financial regulation – specifically, how ongoing changes and new rules have impacted capital requirements and collateral needs, causing supply to tighten while demand increases.

For many firms in the space, increased operational complexity is the result. From the sudden need to co-ordinate an entire workforce of remote employees to parsing the consequences of a major political situation such as Brexit or an extreme unexpected event like a global pandemic, buy-side firms need to address these changes and integrate new strategies that will help them navigate such one-off events and manage continued regulatory change.

The Eurex perspective

The market turmoil seen in 2020 has accelerated several key trends that were already evident before the onset of the pandemic. For instance, many market participants – particularly on the buy side – are now focusing more than ever on the evolution of their liquidity and collateral management arrangements. It is clear market infrastructure providers have a key role to play here. For example, central counterparties have, over the past decade, made significant contributions not only to making markets safer and more resilient, but to boosting efficiency for clients in terms of collateral and liquidity management.

Eurex takes the approach of striking a fine balance between strong risk management and delivering the best possible efficiencies for members and their clients. As part of this, Eurex's ambition is to offer a full spectrum of euro-denominated fixed income products – ranging from listed and over-the-counter derivatives to securities

financing – and build on its position as the 'home of the euro yield curve'. From operational and risk perspectives, an integrated offering such as this is key to achieving the sought-after balance: minimising risks in the market and, at the same time, making the market more efficient. To achieve these ambitions, we are seeking to diversify our membership and bring cleared repo to buy-side clients via initiatives such as ISA Direct.

This white paper provides some key insights into the current state of play for buy-side organisations. What has been made clear is that the benefits of new access models – improved execution terms, strengthening risk management and ensuring access to liquidity during unexpected market upheavals – are widely known. Yet there is still work to be done in terms of adoption. We at Eurex are fully committed to driving adoption in close co-operation with our clients in the coming months and years.

Identifying the key issues of the past 12 months

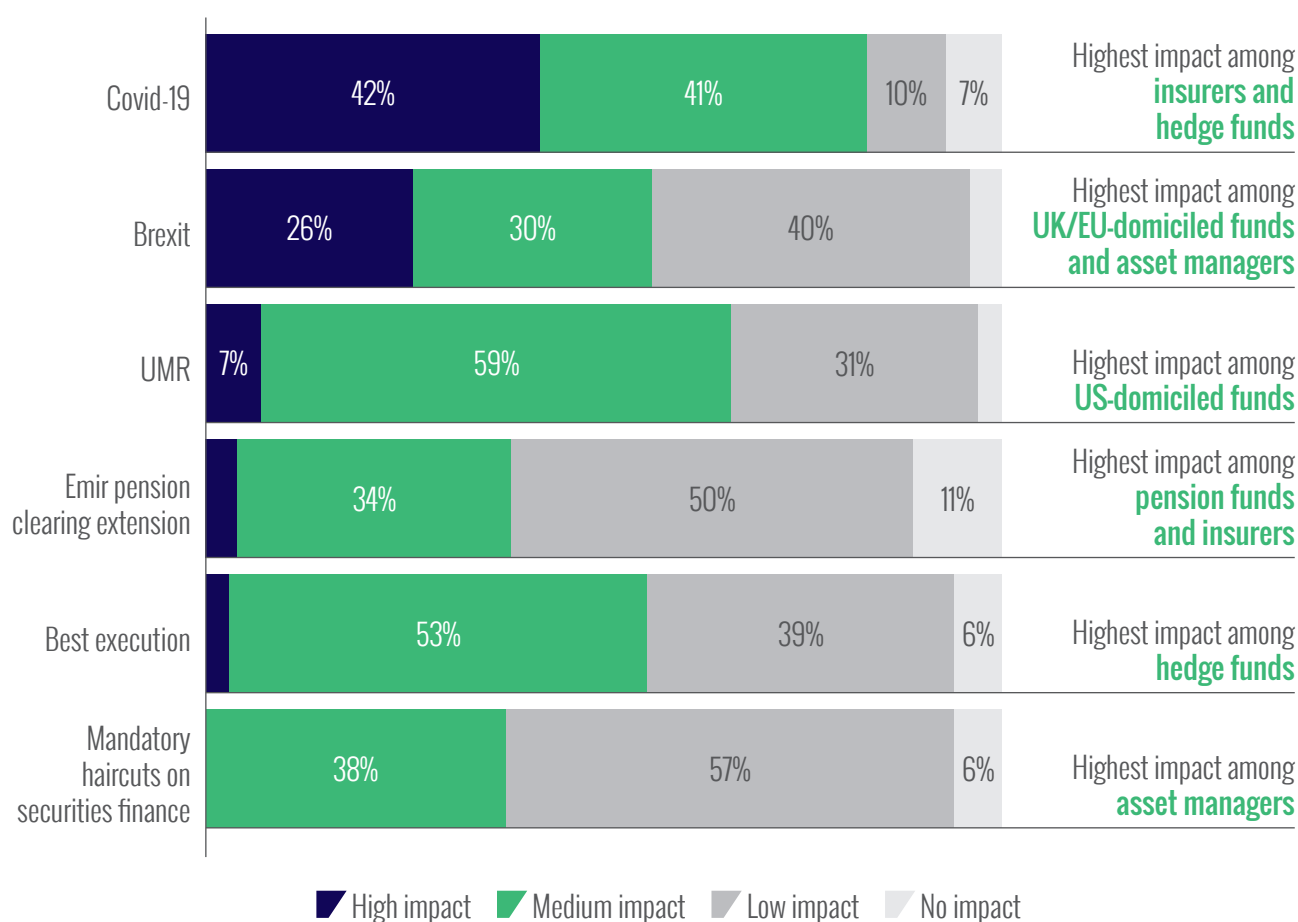
A number of issues have affected the ability of buy-side organisations to manage derivatives, liquidity and collateral over the past 12 months. Covid-19 has had the most severe impact across all buy-side organisation types polled for the survey in Q1 2021. While 42% of respondents rated the impact on their ability to manage derivatives, liquidity and collateral as ‘high’, a further 41% said the pandemic had a medium impact on these parts of their businesses (see figure 1). Only 7% of respondents said Covid did not affect these areas.

Rated on the same criteria, Brexit had the most wide-ranging impact. As you might expect, EU- and UK-domiciled firms – as well as firms managing high levels of euro-denominated funds – were most affected, with more than 85% of these groups ranking Brexit as a medium- or high-impact issue.

Survey respondents say best execution requirements and UMR have also affected their ability to manage derivatives, liquidity and collateral over the past 12 months, with a majority referring to a medium impact.

The impact of significant events such as Covid-19 and Brexit, as well as the need to manage ongoing regulatory change, has led to concerns about operational complexity and market volatility among buy-side firms. According to the survey results, these issues posed the greatest challenges to derivatives, liquidity and collateral activity over the past 12 months and are also seen as the biggest challenges in the next 24 months (see figure 2).

1 Impact of issues on the ability to manage derivatives, liquidity and collateral



When managing derivatives, liquidity and collateral over the next 24 months, further bouts of market volatility remain a key issue for this part of the market. This is particularly true for traditional asset managers, the survey shows, while pension funds' number one future concern is instead "access to derivatives/trading liquidity".

In anticipation of continued volatility, the survey reveals that buy-side firms have started to rethink their priorities for the next two years. In this environment, most respondents intend to increase their use of central counterparties (CCPs) for cleared repo when managing initial and variation margin. This is closely followed by plans to increase the use of collateral transformation for initial margin. For traditional asset managers, the latter was the top choice when questioned about any preparations for future volatility (see figure 3).

The survey also shows that respondents see CCP-cleared repo as the most useful source of repo during any future bouts of market volatility. Although bilateral sources from banks ranked second in the overall results, it was the top source for insurers, pension funds (jointly with client platforms), as well as among EU-domiciled organisations (jointly with cleared repo) and those with high levels of euro-denominated funds (see figure 4).

2 The most challenging issues related to derivatives, liquidity and collateral activity over the past 12 months, versus the next 24 months

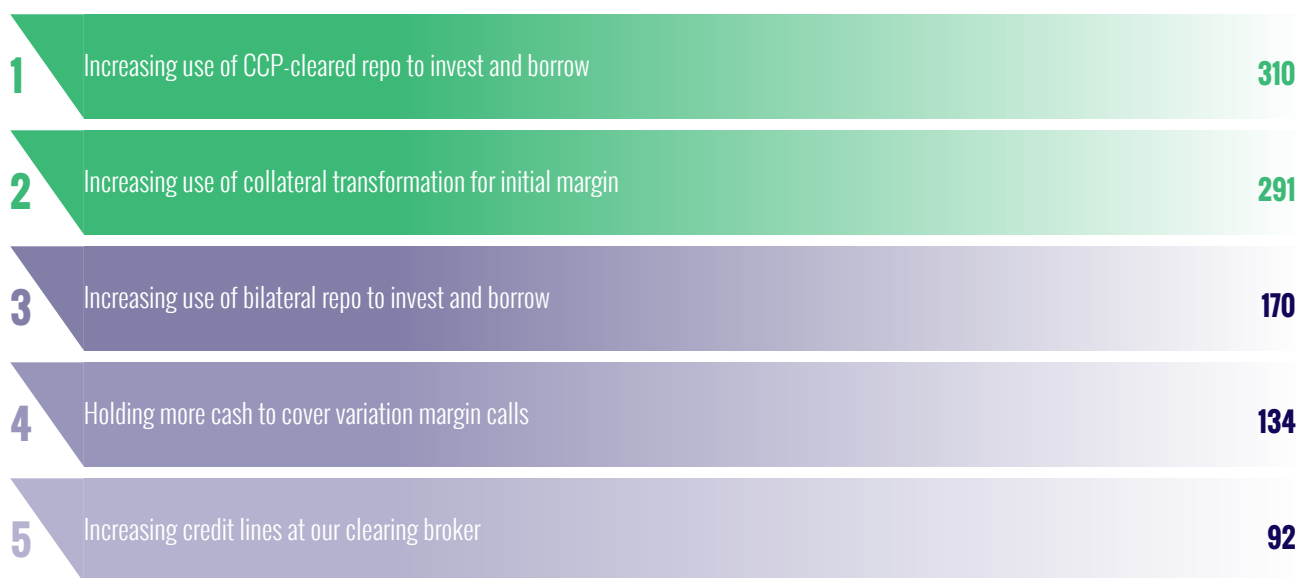
Past 12 months		Next 24 months	
1	Operational complexity 134	1	Market volatility 177
2	Market volatility 121	2	Operational complexity 117
3	Concerns about business continuity 57	3	Access to derivatives/trading liquidity 52
4	Access to financing liquidity 49	4	Access to financing liquidity 45
5	Access to derivatives/trading liquidity 48	5	Concerns about business continuity 25
6	Collateral management 26	6	Collateral management 21

Ranking based on respondents' aggregate scores of the top three issues

In line with this finding, the survey results indicate that nearly half of respondents plan to use or consider CCP-cleared securities finance services to manage liquidity over the next 12 months. In fact, all but 6% of respondents are either already using such services (28%), plan to in the next 12 months (49%), plan to set a timeline to do this (10%) or are at least considering such a change (7%) (see figure 5).

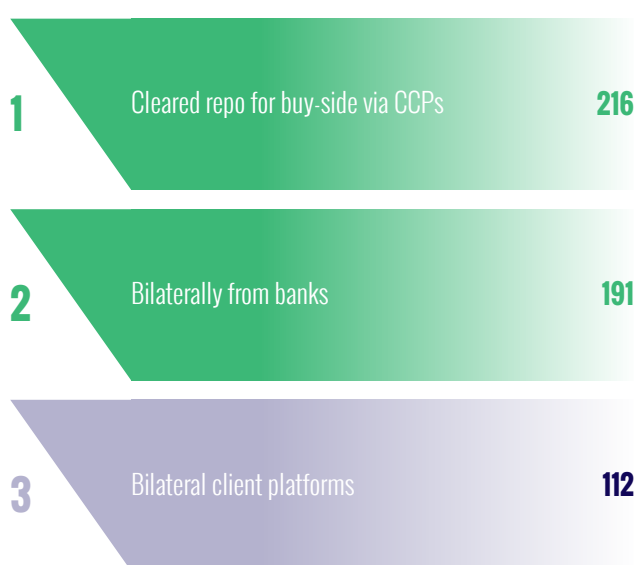
While nearly one-third of respondents already use CCP-cleared repo, according to the survey, exact numbers differ across subsectors and regions. For example, only 16% of insurers are already using such a service, but 64% plan to in the next 12 months. Similar numbers of European (65%) and euro-focused (60%) firms also plan to switch to such a service in the next 12 months.

3 Priority actions for managing variation margin and initial margin in preparation for future volatility



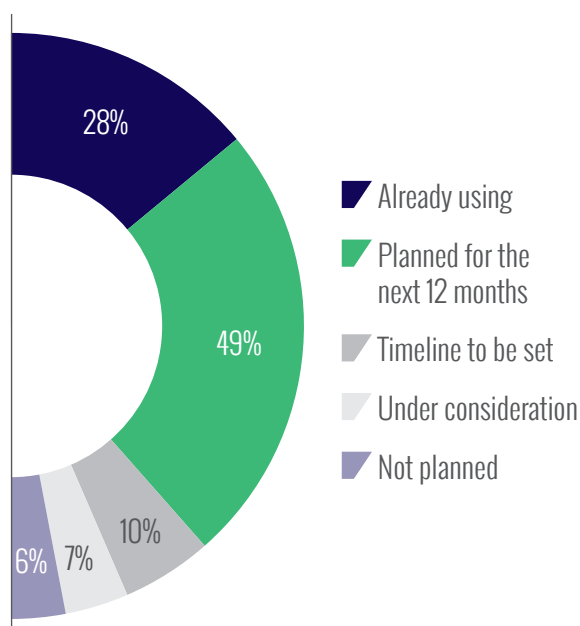
Ranking based on respondents' aggregate scores of applicable priorities

4 Most useful sources of repo during future bouts of market volatility in the absence of central bank support



Ranking based on respondents' aggregate scores of applicable sources

5 Use or consideration of CCP-cleared securities finance services with regard to managing liquidity



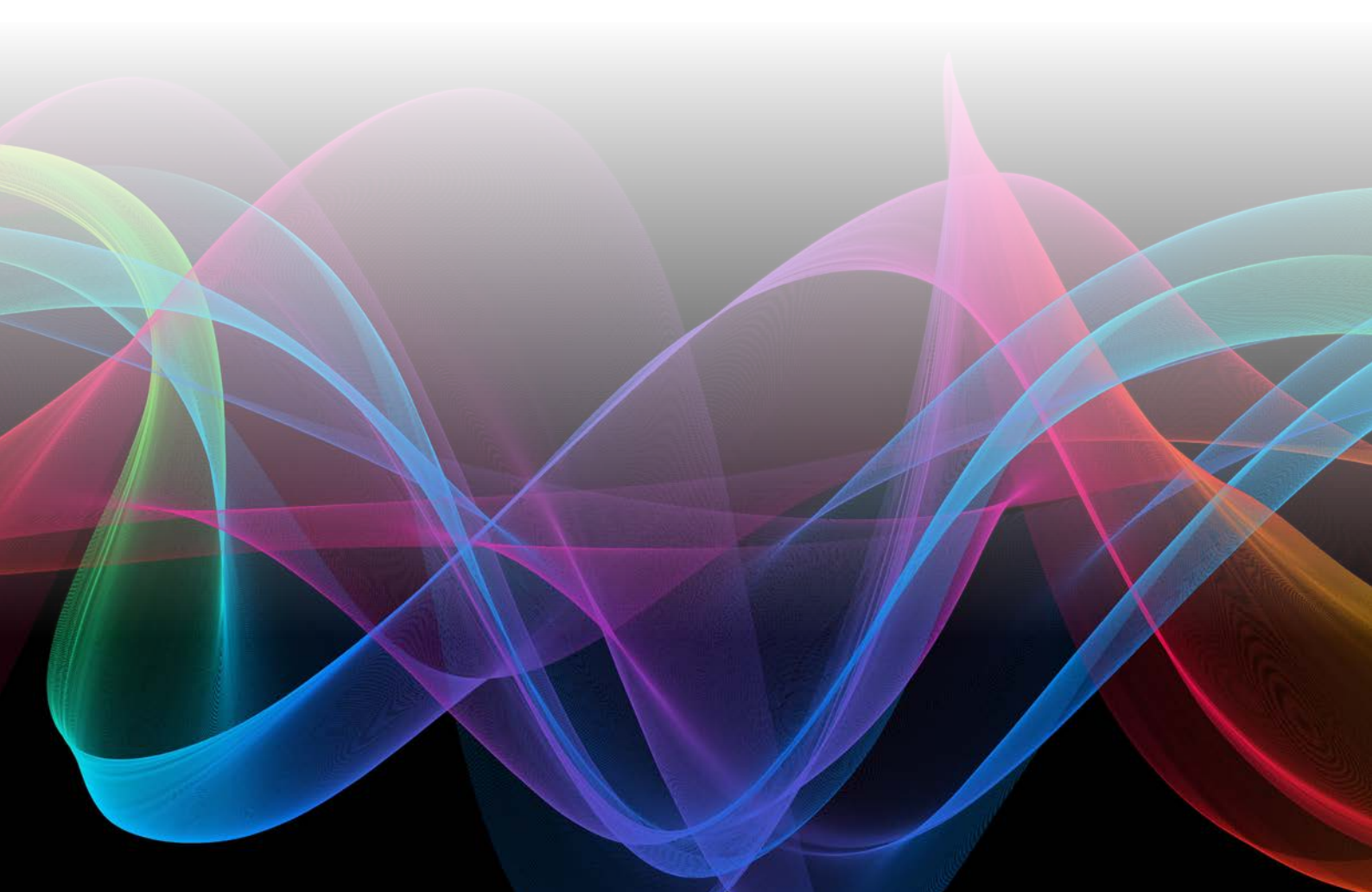
Optimisation and integration are key themes for buy-side firms going forward

In addition to navigating market volatility in real time, buy-side firms are working to translate lessons learned last year into new strategies in areas such as derivatives trading and liquidity and collateral management. The survey indicates that buy-side firms across all subsectors plan to work on improving processes and efficiency when it comes to future business priorities, for example. This could provide a more robust foundation during bouts of market volatility.

In relation to derivatives portfolio management, there is a clear intention to improve collateral or margin management and optimisation capabilities. While collateral management and access to liquidity did not rank as the most challenging issues overall, it appears collateral optimisation is becoming a priority – less driven by recent challenges, but more as a general area of improvement to ‘put the house in order’.

The second-ranked future priority for derivatives management is to conduct more CCP-cleared derivatives business versus bilateral clearing. This is a top priority for hedge funds in particular.

Continuing on the same theme of ‘improving systems and processes’, the survey reveals similar future plans in relation to the priority list for liquidity and collateral management at many buy-side firms. For example, ‘proper integration of liquidity and collateral business into order management systems’ is a top priority for the buy side in general, as is the need to ‘reshape or reposition the collateral management function’. ‘Streamlining operational processes’ and ‘moving to electronic execution’ also scored highly overall.

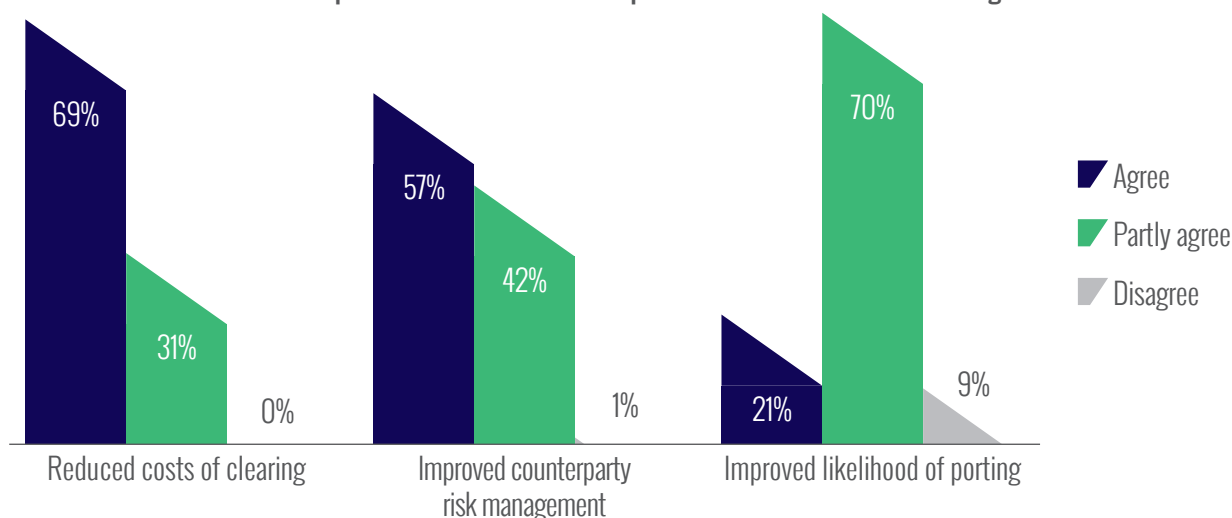


Recognising the benefits of direct access models

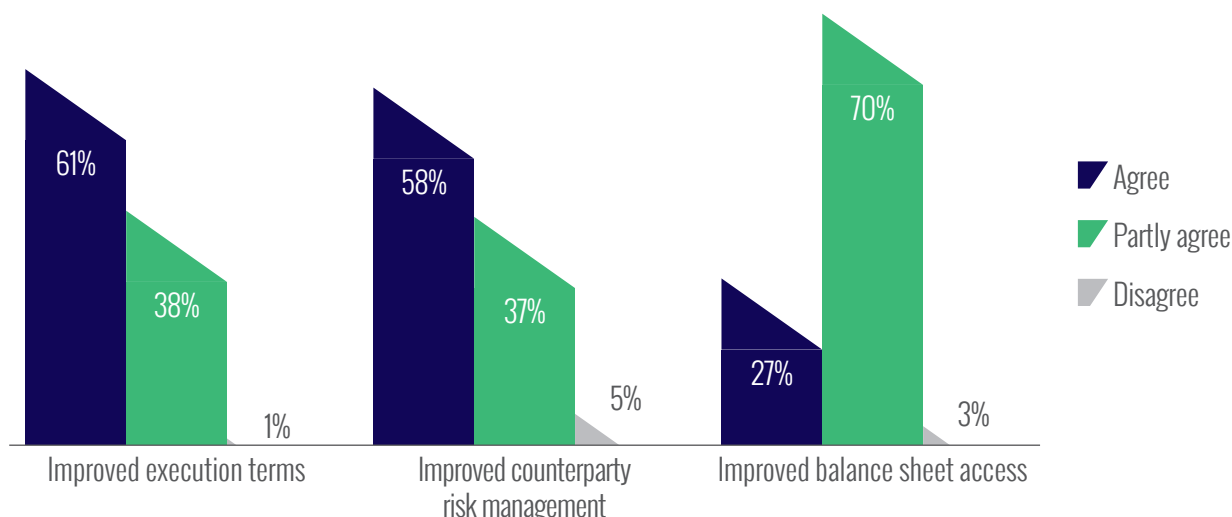
The survey highlights buy-side concerns about future volatility and continued operational complexity. It also provides some insight into survey respondents' stated priorities going forward. The results indicate that buy-side firms intend to prepare for the future by improving processes and creating more efficiencies around derivatives portfolios, liquidity and collateral management. For many, this will involve streamlining operational processes and integrating liquidity and collateral businesses into order management systems.

When it comes to derivatives portfolio management and liquidity and collateral concerns, using integrated clearing and direct/sponsored access models could help organisations streamline in this way. A direct model allows a buy-side firm to establish a connection with the CCP, while the clearing agent continues to oversee default management and fund contributions, among other services. The survey results present a clear understanding across all groups of the main benefits of such a strategy, including improved counterparty credit risk management and reduced clearing costs. Compared with traditional client clearing of derivatives, 69% of respondents agree that direct access reduces clearing costs, while 57% acknowledge the improvements gained in relation to counterparty risk management. And, compared with bilateral settled repo transactions, 61% of respondents concur that direct models lead to better execution terms and 58% see the opportunity for better counterparty risk management (see figures 6 and 7).

6 Perceived benefits of direct/sponsored access models compared with traditional client clearing of derivatives



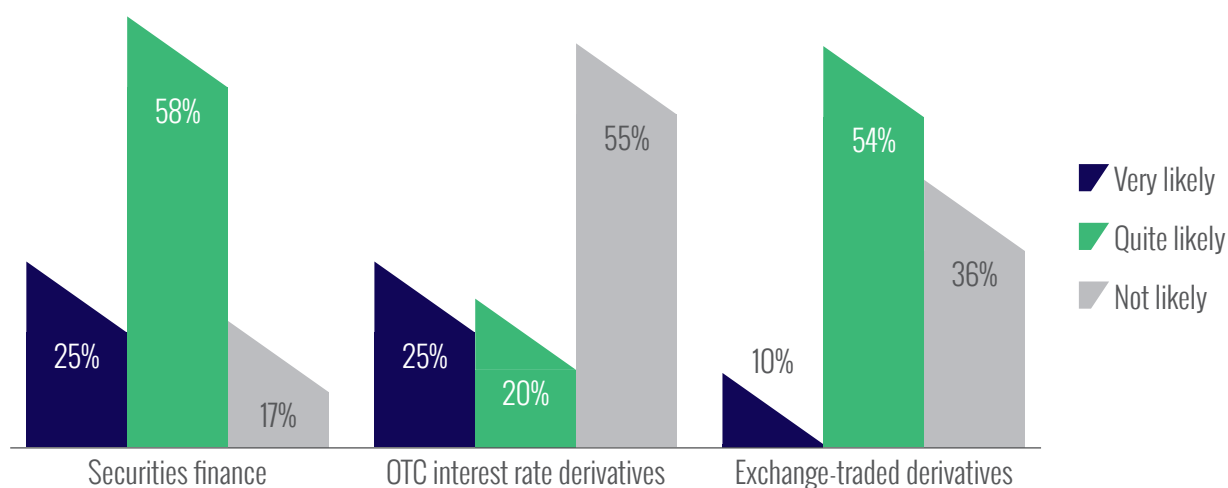
7 Perceived benefits of cleared direct/sponsored access models compared with bilateral settled repo transactions



The survey results also show a clear appreciation among all groups of some of the key benefits of integrated clearing. Respondents see cross-product margining and, to a lesser extent, collateral reuse as the most valuable features of an integrated clearing model. The benefits of such models are clear, particularly in an environment in which buy-side firms are concerned about ongoing operational complexity and expecting market volatility to continue. The survey illustrates a strong appetite among all groups to move to a centrally cleared direct/sponsored access model for securities finance products – more than 80% said they would be very likely or quite likely to do so. Nearly two-thirds of respondents (64%) expressed interest in using such a model for exchange-traded derivatives, while 45% say they are quite or very likely to consider this type of model for over-the-counter (OTC) interest rate derivatives in the future (see figure 8).

However, some concerns persist about such models among buy-side firms. The perceived complexity of the legal framework and the ability to cope with CCP margin calls ranked highest as barriers to entry, although very few see ‘insufficient benefits’ to moving to a direct/sponsored access model for CCP-cleared transactions, or voice concerns about agent availability. Some organisations, particularly those in the US, were more likely to report there was still a lack of awareness and understanding of these models, suggesting there is still some work for providers to do in communicating the features and benefits (see figure 9).

8 Likelihood of moving to a centrally cleared direct/sponsored buy-side access model for specific products



9 Barriers to moving to a direct/sponsored buy-side access model for CCP-cleared derivative or repo transactions



Ranking based on respondents' aggregate scores of the top three barriers

Conclusion – Preparing for the future

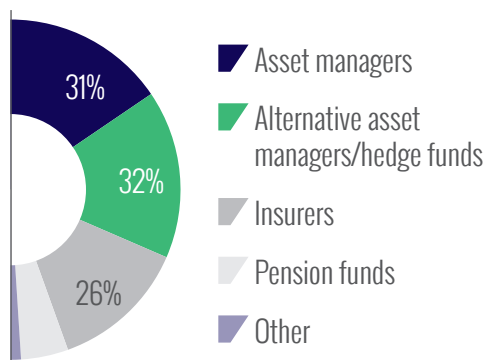
While the market clearly sees value in using direct access models for clearing derivatives and repo transactions, buy-side organisations have been prioritising more immediate concerns as the market emerges from the darkest days of the Covid-19 pandemic. In particular, the impact of restrictions imposed by governments around the world on the global economy have been keenly felt. This has resulted in operational challenges such as the need to help employees work remotely or in smaller groups. Organisations are still working on integrating much-needed solutions to such issues, some of which have the potential to spur permanent change for many buy-side firms.

However, the survey also shows that future-proofing derivatives portfolios and managing collateral and liquidity issues remain firmly on the agenda. Buy-side firms see the value of adopting new methods such as direct access models. The benefits are understood: improving execution terms and strengthening counterparty credit risk management, as well as ensuring access to liquidity in crisis situations. Some barriers to sector-wide adoption remain, but the simplification of issues such as CCP legal frameworks and operational requirements could spur faster and more efficient take-up of direct/sponsored buy-side access models for CCP-cleared derivative and repo transactions in the coming months.

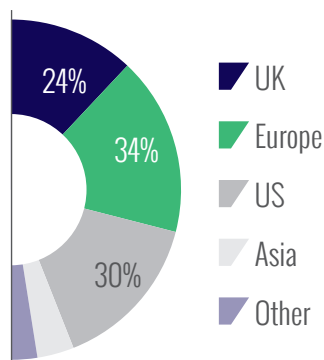
About the survey

Risk.net sought the views of a cross-section of senior executives leading derivatives trading and strategy at buy-side organisations in the UK, Europe, the US and Asia. The results are drawn from a total of 89 valid responses to the survey completed in February 2021.

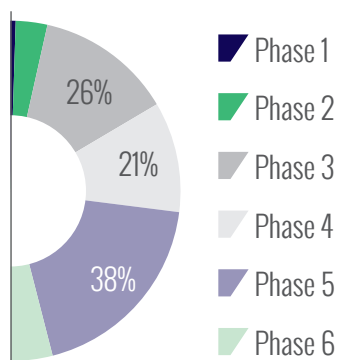
Organisation type



Region where funds are primarily domiciled



Phase/expected phase of UMR



Investment/trading activity conducted (€)

