ROUND TABLE: INCUBATING INCUBATION

ROUND TABLE PARTICIPANTS:
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Clive Furness, Managing Director, Contango
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Patrick Towell, Joint CEO, Cinegi Media and Golant Media Ventures
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Futures industry participants have clearly been under immense pressure in the past few years as they struggle to cope with the seemingly never-ending slate of regulatory measures imposed on them as a result of the financial crisis. As the need for investment in resources and technology to comply with the new regulations has mounted, most people recognise that very little time and effort has been focused on innovation.

The recent InfoNet 'Incubation' session looked at ways that new products (in terms of traded contracts) and new processes and services could be nurtured against this background. A mixed group of entrepreneurs from outside the mainstream derivatives business discussed the issues together with industry specialists.

Overcoming the obstacles to innovation – a question of time or mindset?

Most participants agreed that finding innovative solutions to issues, although difficult in these times, was necessary to move the industry forward. The key difference among the panellists seemed to be on the best way to allocate the increasingly precious resource of time, with the entrepreneurs arguing that potential industry customers did not spend enough time with them investigating potential solutions.

Others argued that having a more open mindset to new ideas was a prerequisite for derivatives industry renewal. Clive Furness was perhaps most forceful in this respect, believing the exchange traded derivatives community to be too complacent. "We're in real danger of letting ourselves be overtaken by something that we've not seen coming," he said. "I'm a great believer in the 'if it's fine, let's break it' way of thinking. The industry should be questioning itself every time someone says, 'You can't do that' for such and such a reason. I appreciate that the industry is hard pressed but it owes it to itself to find out what the next solutions will be. It should at least be open to opportunities and new concepts."

Like Furness, Mark Beeston believed more forward thinking is necessary. "For me, a good deal of innovation is stifled by people saying 'Yes, but...' Unfortunately that stops things dead in their tracks. What I would say is that we need to surround ourselves with people who say 'Yes and...'"

He was, however, encouraged by seeing some initiatives in the exchange and clearing house space. "Some firms are seeing the need to innovate on behalf of themselves, their clients or the wider industry as a whole," he continued. "They are starting to take the responsibility for building these solutions in conjunction with others because once built, they know that they will be good products, because they have clients demanding them."

According to Beeston, a major drawback is getting the opportunity to discuss new ideas with potential customers at major institutions. "When the customer sets up a meeting for three weeks' time they think 'Oh, that's good, I've got a slot to see these guys.' But the guy at the other end is thinking, 'that's several thousand pounds of burden to me.' I'd say that everybody's time is very valuable. The value of time to an entrepreneur

that is burning money trying to solve your problem is critical. To put it in it in listed derivatives terms, I think he's got a lot more theta than you do."

Beeston also compared the buying cycles of large institutions with the survival cycles of entrepreneurial companies. "The two simply don't match up," he said. "That makes it difficult for early stage entrepreneurs trying to sell into first tier institutions to get a pace of adoption that works."

Brendan Bradley described the drivers behind his exchange's approach. "We've tried to foster innovation with some of the early stage investments that we've made. But it has been prescriptive because we're not a VC. An investment has to be strategic and there are tick boxes to ensure it fits this or that requirement. With respect to the open innovation platform we launched recently we understand that we won't always be the right people to talk to, because we may only choose one in ten proposals, but we may know somebody we could introduce you to. That may be the way to get the innovator's foot in the door."

FCMs – under pressure but trying to innovate selectively

Andy Ross was keen to emphasise the pressures he, his colleagues and peers are under. "At Morgan Stanley, we put our clients' interests first by ensuring that we provide them the service they need, offering new solutions to help navigate the regulatory environment. However, there are significant challenges to innovation when the downside to getting it wrong has the potential to impact your firm as a whole. In addition to market and operational risks, we also factor in franchise risk, which makes the process of innovation more demanding."

Terry Hollingsworth saw similar pressures to Ross. "We try to automate and provide scalable solutions as much as possible but you have the pressures of dealing with client queries and ever-changing regulations and so the spark of innovation inevitably goes on the back-burner."

Both Hollingsworth and Ross said that they are forced to be selective with their innovation initiatives. "In a changeable environment such as this, it's easy to become distracted by the new, shiny thing," according



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Andy Ross, Morgan Stanley

to Ross. "But we have taken the decision to focus on a specific set of innovations. By not being distracted, and having a laser focus on what we're doing, our clients can really benefit from the attention, effort and energy being put into the process."

And Hollingsworth admitted that while, in an ideal world, innovation would be at the forefront of these firm's activity, "We end up having to pick one particular thing that we can all work on as a group at Citi and then really make sure that we get that right."

Despite the pressures of coping with the regulatory change agenda, Ross also sees opportunities. "While the regulatory environment has made some processes more time-consuming and expensive, it has also given us an opportunity to improve them and add commercial value. I don't see it as a series of boxes to tick, but rather an opportunity to understand our clients' requirements which builds on and strengthens our offering."

He also sees the opportunity to improve communication internally. "My colleagues across



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Clive Furness, Contango

departments, such as operations and trading, face different challenges and often speak a different language," he says. "The new environment has driven communication helping to open new opportunities, such as through new traded products or the dynamics of pre-and post-trade processes."

Working together on utility solutions

The possibility of joint industry approaches to incubate innovation was a recurring theme of the session. Bradley felt that there are certainly issues which are non-competitive which could be looked at. "In today's environment, most FCMs can't afford to build solutions themselves. Could a trade association or another group foster that approach? Is it possible that banks might get together to prove a concept and contribute towards new ideas? Or are we all too busy competing with each other to find them?" he asked.

Beeston believed that such cooperation was desirable, saying, "The FCM community have made it clear that innovation is not easy in these times when they are regulated so strongly. Perhaps they could partner more closely with organisations which aren't quite so restricted; where they are more likely to be able to come back with the 'Yes and' answer and build products and services as JVs, partnerships and consortiums."

Hollingsworth agreed that partnerships should be possible in the new environment. "We do share many of our customers. When a customer says that they will give us a certain amount of their business across prime brokerage, we no longer gain any competitive edge by saying that they should place more business with us. They are very systematic. We know how much business we'll get because that's how much counterparty risk they are comfortable with having with us. There may be 5 per cent up for grabs, but if we can stop competing for that and save 20 per cent of costs, it's a no-brainer. So we could partner with other clearing brokers and look into sharing the necessary technology and costs to find a platform that could be shared with the industry."

Speaking as an industry outsider, Patrick Towell was confident from his own experience of the collaboration paradox: "By working on common standards, necessary to the competitiveness of the sector as a whole, firms can find ways to collaborate even in competitive areas, to benefit the growth of the sector as a whole. These hybrid relationships, simultaneously collaborating and competing, are part of the paradigm shift."

Beeston emphasised the need to identify the services it would be possible to commoditise. "If we could 'utilitise' these services, then companies might be able to focus on more innovative initiatives," he said. "Would 'know your client' (KYC) processes be 'commoditisable'? The information could be centralised and the FCMs would become users of it. They might not be responsible for it but perhaps that could be a regulated responsibility for a service provider. It would massively simplify the space in which they operate."

Others believed that a centralised hub, external to all of the FCMs, holding information on the full picture of a counterparty's risk position would be highly beneficial. There would be no need for the utility to send out information but to be available for interrogation.

Stephen Taylor believed that there would be room for third-party/ISV service provision to grow under those circumstances. "Additionally," he said, "Commoditising certain aspects of the service delivery process would help the industry because by driving down costs you can free up money for trading."

Beeston also pointed out the major disparity between the small start-up company with an idea and a consortium constructed to build something that the industry agreed needed to be 'utilitised'. "If a big problem needs a 'utility' solution there will be a limited number of larger companies to contact. The entrepreneurial institution won't get a look in," he said.

"But large organisations can be better incubators by recognising that often these technologies can be adopted incrementally. If you want a new reconciliation platform, for example, you don't have to junk your old one anymore. For an immediate fix you might be better served by somebody coming in with an entrepreneurial solution. In turn, entrepreneurs would be greatly helped if larger firms were more open in considering quite small products. They would have a better idea of validation, future saleability and scalability. There is a big asymmetry with some of the processes around the edges of the FCM franchises that you can more easily give away without taking too much career risk and really start to foster an entrepreneurial culture."

Paul Marks underlined the need for more standardisation in the industry but also believed a lot of innovation was going on. "But it's tied up in a few big vendors and firms and if we believe we need to get access to new start-ups etc, then there does need to be some sort of provider willing to act as an incubator so that firms are dealing with entities that have some credit history and record of delivery."

Parallel universes – what can the derivatives industry learn?

Speaking from his external view, Towell emphasised the value of studying innovation in one arena and applying it to another using his recent experience in the intellectual property area.

"We recently published a report on creating products for intellectual property that are tradable and financeable. There are many comparisons between those intangible assets and financial instruments and there are derivative products that come from them, that are similar to financial derivatives," he explained. "Very few people make those connections. Quite often the best way to innovate is to steal an idea from another sector and put it in yours. It's amazing how you can take a wholesale idea, for instance, from theatre and apply it to film marketing. Or, in this case, from financial trading and apply it to intellectual property."

"One of the keys," he said, "is to involve multiple disciplines. What has been unusual in a lot of the projects that I've worked on is that they've aimed to bring about change to the whole supply chain. Even though we may have been contracted by one player, we've understood that the boundaries are fuzzy and things are distributed across multiple players, even down to the detail of individual business processes. And if those elements are not modelled correctly in requirements or in the questions that are being asked then the answers become 'point solutions' all the time."

Is it time to look for more hybrid models in developing new traded products?

Innovation in product development has largely focused on OTC products coming in to the cleared environment in recent times and some believe true innovation is lacking.

"The classic futures contract has been around for many years and in certain asset classes it is not as appropriate as it has been, particularly the commodity models. Are there other models?" asked Furness. "Could we work with other risk management institutions such as the insurance industry, for example, to work out more hybrid models?"

Furness then cited his recent experience in emerging markets where the need for an alternative model of developing traded products was obvious. "In Africa, for example, you have to look for things in product development to suit their model, not yours. It's got to be different. There is such an imbalance between the sell-side, generally smallholders and the buy-side who are larger institutions.

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Brendan Bradley, Eurex

come up with something that doesn't replicate the traditional Chicago, London or Frankfurt contract specification. How much of a new design does it have to be to make that product accessible to the farmer? Do you have large contracts or small contracts? How do you structure the mini contracts so that somebody with micro-finance can use it so as not to have to sell their product this week, but can hold it for a month in a warehouse. Then, how do you engage warehouse finance?"

Bradley acknowledged that both the process and the cost of developing new contracts had altered dramatically. "In terms of product innovation, exchanges used to be the incubators of new products and the members owned those products," he said. "Now, to a certain extent, we've gone back to that with our GMEX investment. We don't own it, but we're supporting something new."

"The cost of introducing a new product has increased considerably," he continued. "We've probably been working on some of the products we've announced recently for two to three years. There has been a lot of work and investment but we have no income coming from them and there's no guarantee we will do in the future but we have to keep doing it."

According to Ross, FCMs are working together with exchanges on innovative new product development. "That is us displaying intellectual capital," he asserted. "It's not just about taking some career risk; it's looking at the opportunity cost of time and effort and building on that. If you pick the right partners and you focus, you can get things to happen. The OAT future we launched with Eurex and some market-makers is a great example of that."

Taylor took a different tack, pointing to potential protectionism in the behaviour of some exchanges once they had established dominant market share in a particular contract.

"Today's innovation will become tomorrow's Bic biro," he stated. "And we find that once an exchange has that Bic biro, or a commoditised product that everyone wants, they often tend to erect barriers to competition. We're very interested to see that regulators across Europe have started to look at ways of ensuring that competition remains across the board. Regulators have a big role to play, in ensuring that competition is never stifled and that open access in Europe is embedded into the next tranche of regulation. Then we can be sure that there's always a competitive force in place, to move that Bic biro idea forward."

Bradley clearly believes that regulatory change represents a major opportunity, comparing it to the previous catalysts (i.e. the move from floor to screen, the introduction of the euro etc). "From that perspective, everybody has to view this as an opportunity," he said. "We've had all the pain but we have to move forward. The way we've looked at that is through what we call 'Trojan horses'. Perhaps we wouldn't have been as welcome if we had gone to the market place as our regulated entity, Deutsche Börse, but if you can find ways around the regulation, by looking at entities that are the routing and transmission of orders, as opposed to being an MTF, or looking at somebody who's got a buy-side network, that's the way forward."

In a session which hopefully brought greater mutual understanding to both providers of innovation and to hard pressed industry executives, Beeston's summary of the changing balance of power between the exchanges and the banks provided considerable food for thought.

"The exchanges have clearly got the upper hand on innovation right now because the banks are under significantly more pressure," he said. "Banks have been beaten almost senseless for the last five years and they are only just recovering. So, do the exchanges continue to be the innovators? And if the banks don't compete with that, are they the potential losers? The exchanges have the power and the reach to make life very difficult."