Navigating the evolving OTC landscape

STRATEGIES FOR GROWTH IN 2024

Parameta Solutions

Contents

Unlocking OTC market growth: Addressing complexity and data challenges

The global OTC derivatives market is projected to reach more than US$25.81 trillion by 2032, representing a compound annual growth rate of 3.14% over the decade.[1]

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CEO, PARAMETA SOLUTIONS

This considerable growth reflects the recent market volatility which is driving participants to hedge risk and manage their exposure to fluctuations in asset classes, interest rates and inflation.

Enhanced regulatory frameworks governing the use of derivatives which have brought greater transparency and improved risk mitigation have increased confidence in the use of OTC derivatives.

Meanwhile, innovation and technological advances in the OTC market have made the sector a faster, smoother and more effective place in which to operate.

To better understand how the OTC derivatives market has evolved and improved, and to anticipate the challenges and opportunities in the years ahead, Parameta Solutions conducted quantitative research with more than 400 market participants along with in-depth interviews across the buyside and sell-sides globally.

The research reveals that while there have been significant advances in these markets, there is still much for participants to overcome.

Liquidity issues, a lack of transparency, and the need for greater market data all emerge as key opportunities.

Our research reveals that the markets present stronger growth opportunities than three years ago, but continued successful growth depends on greater access to reliable market data and analysis which are the foundations for this critical financial sector.

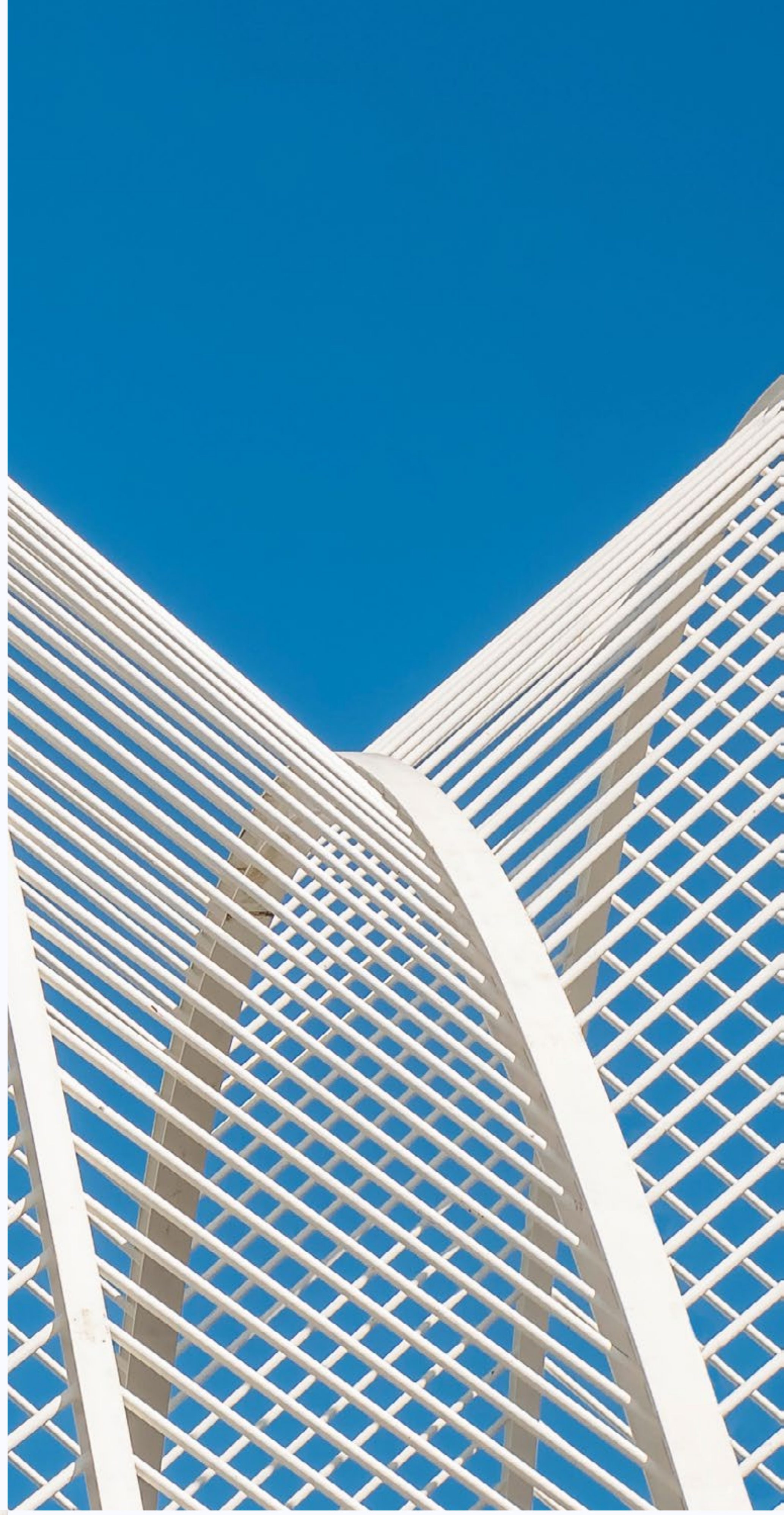
The research also suggests an interesting dynamic between the buyside and sell-side. While there may be some differences in perceptions, it also presents an opportunity for collaboration to create efficiencies for everyone.

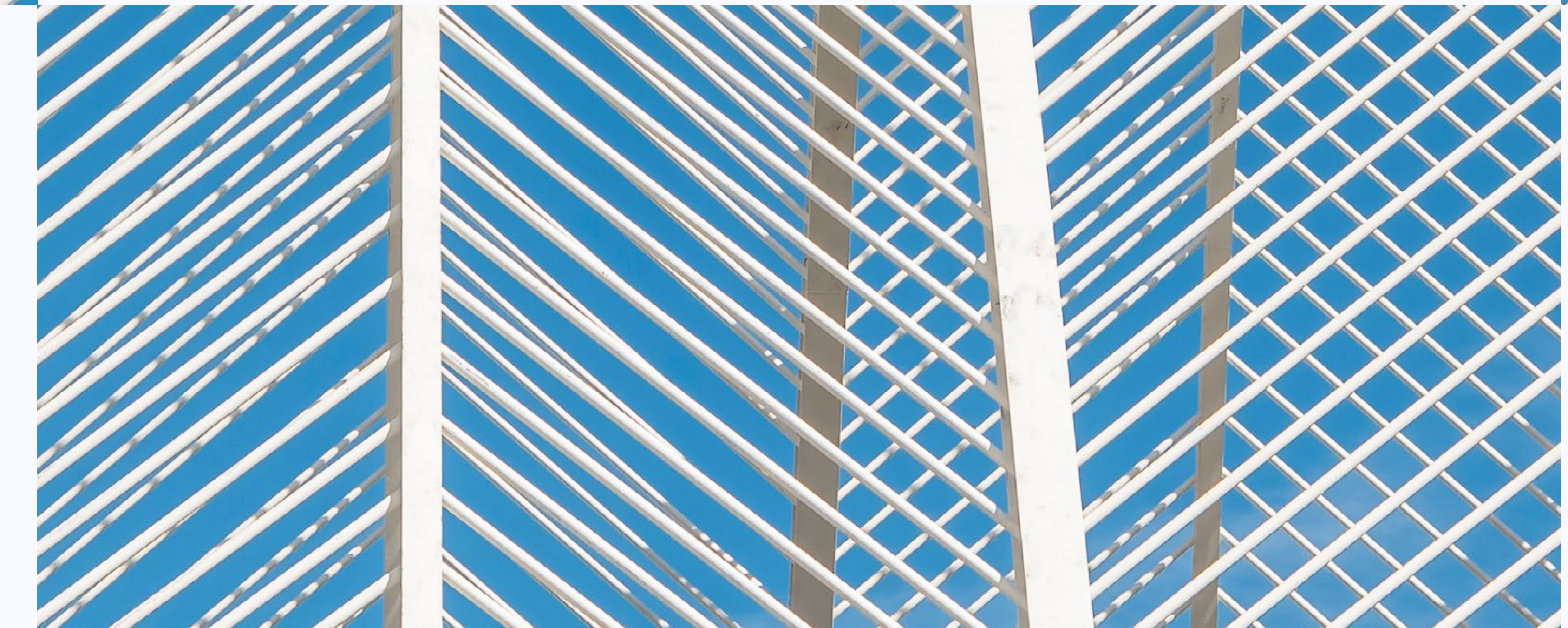
To navigate these evolving challenges, technology and automation offer powerful solutions. We will delve into their potential, exploring both the opportunities and risks presented by advancements in AI and machine learning.

[1] https://www.businessresearchinsights.com/market-reports/triennial-otc-derivatives-market-110216

Methodology

The research was conducted by Censuswide, from a sample of more than 400 respondents who work in one of the following; bank, insurance company, investment company, family office, energy trading / brokerage, hedge fund, asset manager.
One of the following job titles; Broker, Compliance Officer / Manager, Risk Manager, Market Analyst, Pricing Analyst, Investment Strategist, CTO (Chief Technology Officer), have heard of and uses OTC derivatives across the UK, USA, Germany, France, Italy, Spain, Singapore, Hong Kong and Japan. The data was collected between 01.02.2024 and 09.02.2024. Censuswide abides by and employs members of the Market Research Society (MRS) and follows the MRS code of conduct and ESOMAR principles. Censuswide is also a member of the British Polling Council.





CHAPTER ONE

Riding the new wave of technology and innovation

83%

According to 83% of respondents to the Parameta Solutions survey, the OTC derivatives market is an easier place to operate today than it was just three years ago.

Large amounts of innovation and technological advancement have streamlined bilateral negotiations, allowing for greater counterparty connectivity and enhanced pre- and post-trade security.

While all of these innovations have the potential to significantly impact OTC markets, the extent of their impact may depend on factors such as regulatory developments, market structure, technological adoption rates, and the specific needs and preferences of market participants.

Additionally, synergies between these innovations, such as combining blockchain technology with electronic trading platforms or integrating algorithmic trading strategies with Application Programming Interface (API) enabled systems, could further enhance their impact on markets. Ultimately, the most impactful innovation may be the one that effectively addresses key pain points, enhances efficiency, and creates value for market participants.

And whilst Artificial Intelligence (AI) has the potential to bring significant benefits to the OTC markets, there may be caution in adoption until the technology matures.

Sentiment suggests the market is some way off using AI to support decision-making. The "black box" nature of AI makes it difficult to trust its recommendations, especially for high-value transactions. Furthermore, in a heavily regulated market, the opaque nature of AI raises concerns about compliance. This means OTC participants might be unsure if AI decisions align with regulations and worry about potential penalties if something goes wrong.

However, easy-to-adopt, off-the-shelf applications are bridging the gap, making these complex instruments accessible to a wider range of market participants. Respondents told us that technology-driven execution platforms have made the markets faster and more effective, with greater competition between providers and better price transparency.

> Price transparency has always been a challenge, so we need to think about how we bring that to the markets. That's where the development of third-party platforms that consolidate pricing from various providers have started to close that gap a little bit.
>
> **FX OPTIONS TRADER, UK**

However, more innovation is needed – particularly for those trading more complex instruments – to bring speed and efficiency to the OTC derivative space, enhance transparency on pricing and terms, connect counterparties, and improve liquidity and risk management.

The challenge for the sector is to overcome some of the obstacles that our research suggests may stand in the way of technological potential. Most significant of which is a lack of willingness to embrace change either through fear of 'getting things wrong', the difficulties of unravelling entrenched cultures and systems, or a fear that organisations cannot support new technologies such as AI.

WHAT WOULD YOU SAY ARE THE **MOST IMPORTANT** INNOVATIONS?

32%
BLOCKCHAIN AND DISTRIBUTED LEDGER TECHNOLOGY (DLT)

16%
MACHINE LEARNING/ ALGORITHMIC TRADING

13%
CENTRAL CLEARING

9%
API INTEGRATION, CREDIT DERIVATIVES AND FUTURES

Appetite for change

When it comes to innovation, 50% of respondents told us they felt that the markets were "excellent" at adapting and innovating.

Respondents from the banking sector were by far the most likely to rate innovation as excellent (68%), with one respondent pointing specifically to standardisation in processes and ability to work with more participants as major advances.

Hedge funds expressed the most dissatisfaction with innovation in the OTC market, with 66% saying they were less than satisfied.

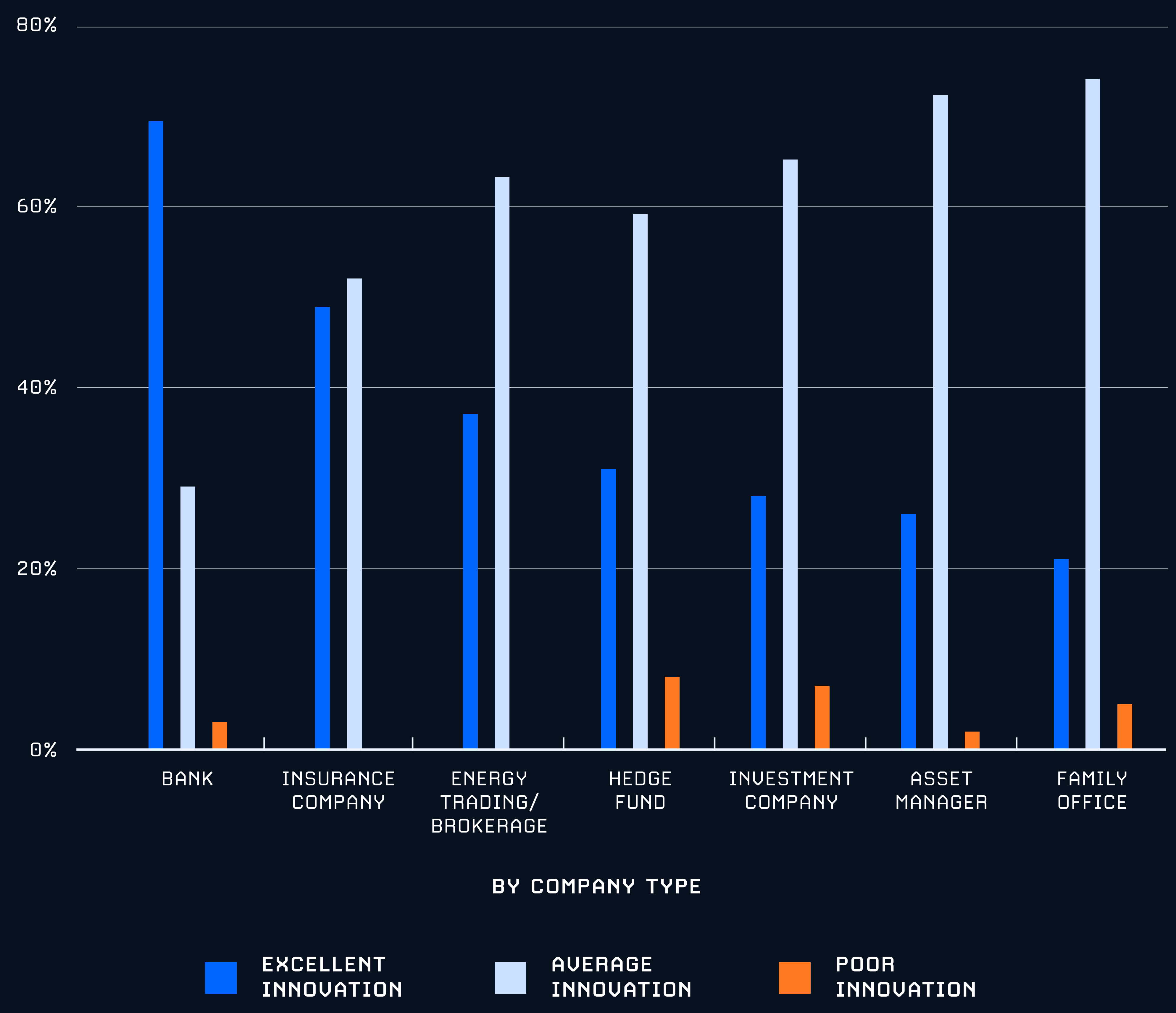
This could be due to a perception that there is a slower pace of change in OTC markets, likely due to their bilateral nature. Unlike exchanges with standardised products, OTC contracts are customised for each trade. This reduces pressure to develop standardised products or rapidly adopt new technologies, which can be frustrating for hedge funds seeking faster innovation.

However, there are positive developments. Some OTC market data providers are creating indices that allow participants to trade new investable funds, opening doors to novel investment opportunities.

Looking across geographies, Europe and the US were most satisfied with innovation from OTC market players. However, looking out to Asia Pacific (APAC), the levels deteriorate.

19% of respondents in Hong Kong say innovation is poor, 81% say average and none say excellent. Whereas in Japan 28% say innovation is excellent, 57% say average and 5% say poor.

HOW WOULD YOU RATE THE INNOVATION FROM OTC MARKET PLAYERS?



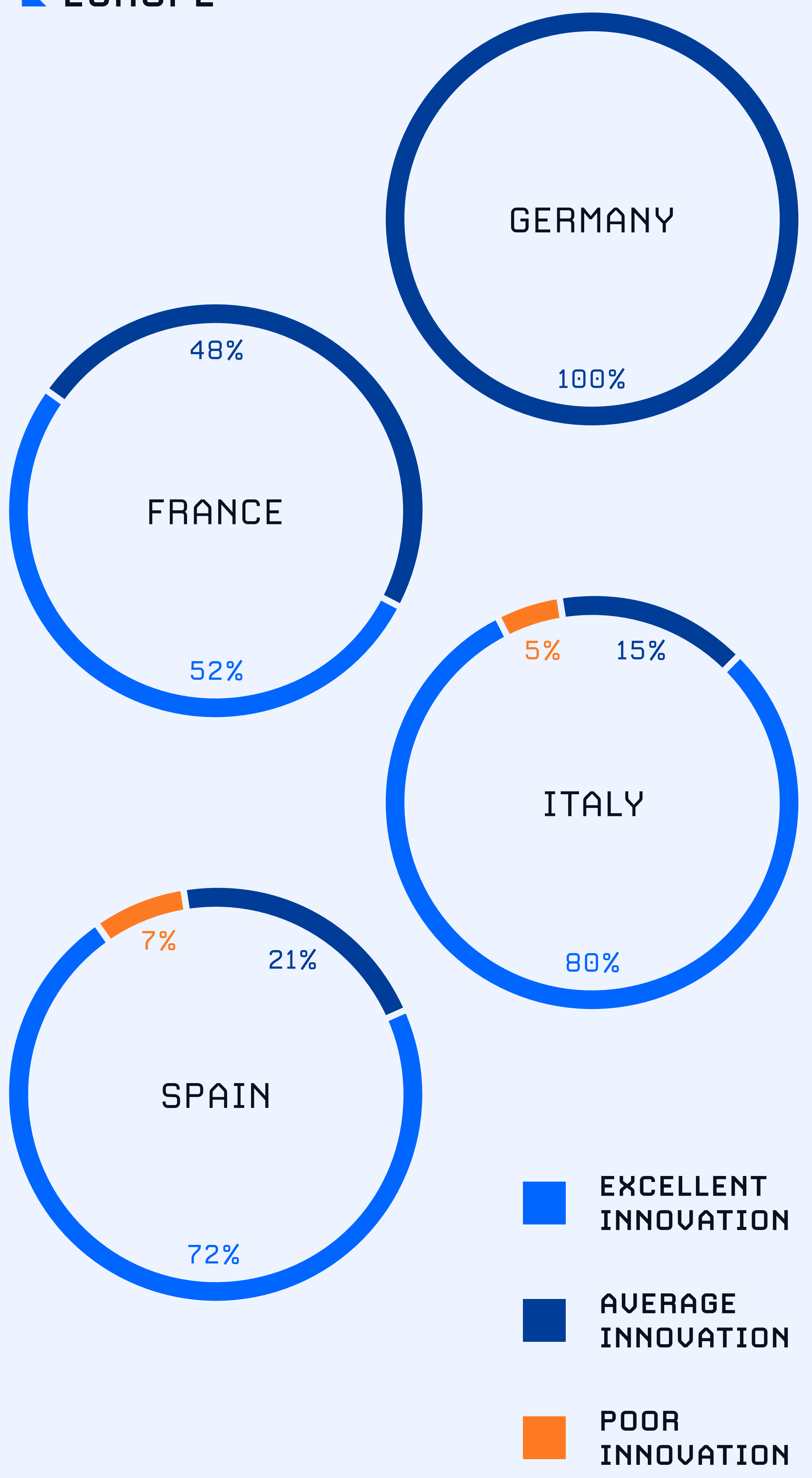
These attitudes may be because participants in APAC OTC markets face two factors hindering innovation. First, stricter regulations compared to North America and Europe could create a less innovation-friendly environment. Second, the region's fragmented market structure limits liquidity and trading volumes, reducing the economic incentive for participants to invest in new solutions.

There is an opportunity for the more developed derivative markets in the US and Europe to help bring innovation to these markets by facilitating technology transfer and promoting standardisation.

> People want to use the same pipes, the same platform. They're not crying out for change. They want to use the same thing over and over again. That stifles innovation.
>
> **INTERMEDIARY, APAC**

HOW WOULD YOU RATE THE INNOVATION FROM OTC MARKET PLAYERS?

EUROPE



Technology's impact on market confidence

While the vast majority of respondents believe the OTC derivatives markets are an easier place to operate compared to three and five years ago, there is a disconnect between the buyside and sell-side views.

94% of banking respondents say they find the OTC markets more straightforward, with two-thirds saying they are much easier.

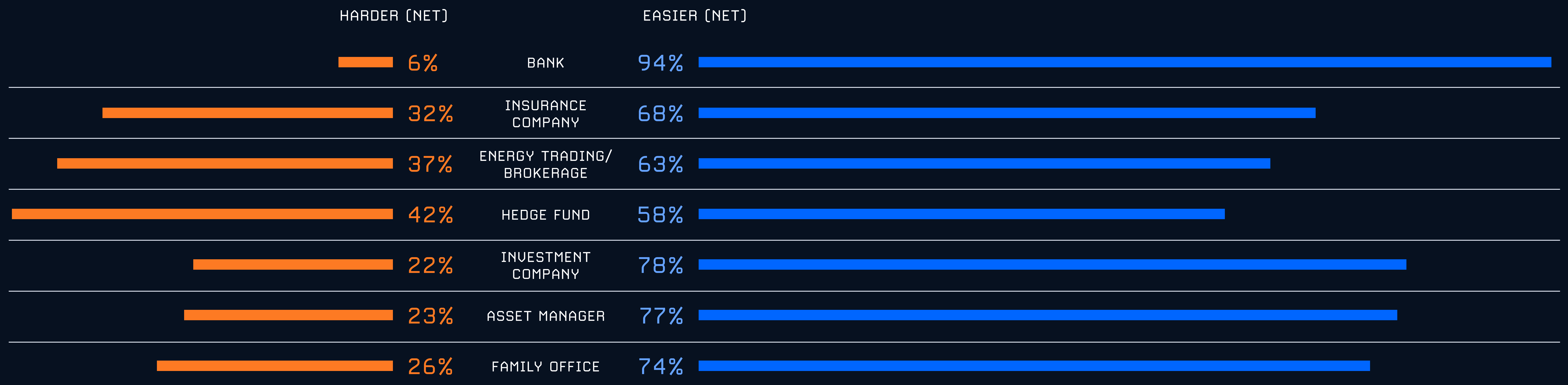
Post-global financial crisis regulatory reforms have significantly eased bank operations in the markets. These reforms have brought much-needed clarity and consistency to market practices, streamlining regulatory compliance for banks. Additionally, the standardisation of products like interest rate and credit default swaps has boosted liquidity and efficiency. This translates to reduced operational complexity for banks, enabling smoother trading and risk management.

However, looking across the different buyside functions the picture was mixed. For example, 41% of hedge fund respondents say the market is harder to work in today than it was three years ago.

Geographically, US respondents are most likely to agree that the market is more difficult (36%), followed by Japan (29%) and Hong Kong (26%).

The unique nature of the OTC market, with its complex instruments and diverse participants, can present challenges for buyside firms accustomed to the efficiencies of exchange-traded platforms.

IS THE OTC DERIVATIVE MARKET **AN EASIER PLACE TO OPERATE NOW** COMPARED TO THREE YEARS AGO?



> If you are a hedge fund that's just looking for a pure play on volatility and are trying to keep costs low and every basis point matters, you're probably not going to spend a huge amount of money on the latest technology.
>
> **TRADER, US**

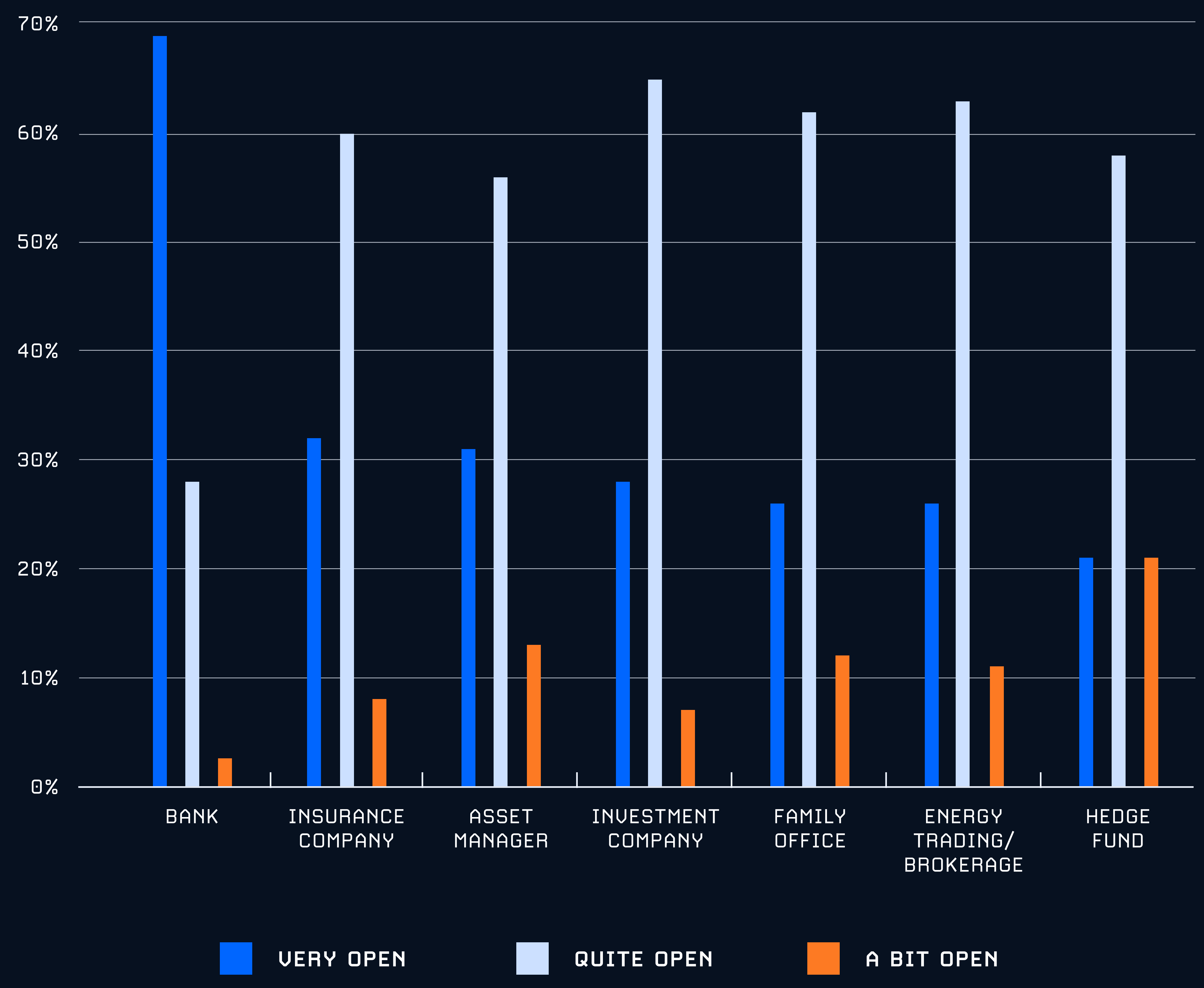
While advancements are being made, the OTC infrastructure may evolve at a different pace than exchanges. Additionally, fragmentation within the market can impact liquidity for certain assets. These factors can make efficient trade execution more complex for buyside firms.

Survey respondents acknowledge that the sell-side has attempted to make it easier for their buyside partners to trade OTC derivatives over the past three years. Almost all sell-side participants (98%) say they have made it easier for the buyside, but the sentiment is more mixed among buyside firms.

When asked about a willingness to embrace new technology, overall respondents believe the buyside is open to new processes that make it easier to trade OTC derivatives with all respondents saying they are receptive to change.

Respondents note that it can be challenging for the buyside to work with the solutions that their banking partners offer. In particular, overhauling their own internal systems to adapt to the sell-side's technology can be cumbersome and costly.

ARE YOUR BUYSIDE PARTNERS OPEN TO NEW PROCESSES TO MAKE TRADING OTC DERIVATIVES EASIER?



One investment manager said, “The buyside have their particular way of working with the sell-side. When another bank comes with a new solution to do something better or faster for them, they have to switch all the internal processes and go through compliance. Change is not easy.”

Hedge fund respondents show the most reticence to new processes, with almost 80% of those asked saying this creates challenges for them.

However, one FX options trader noted that where the buyside may not want to adopt new processes, they could lose competitive advantage, particularly on pricing and settlement.

“If the buyside want to efficiently trade on better pricing they will have to move forward. Fintechs are already pushing the envelope on a lot of different areas. For example, they are looking to settle transactions using Blockchain.”

On a country-specific level, APAC respondents were less optimistic about the buyside’s openness to new processes than their European and US peers.

One buyside trader from Hong Kong says the risk of causing errors when using new systems may hamper appetite for innovation.

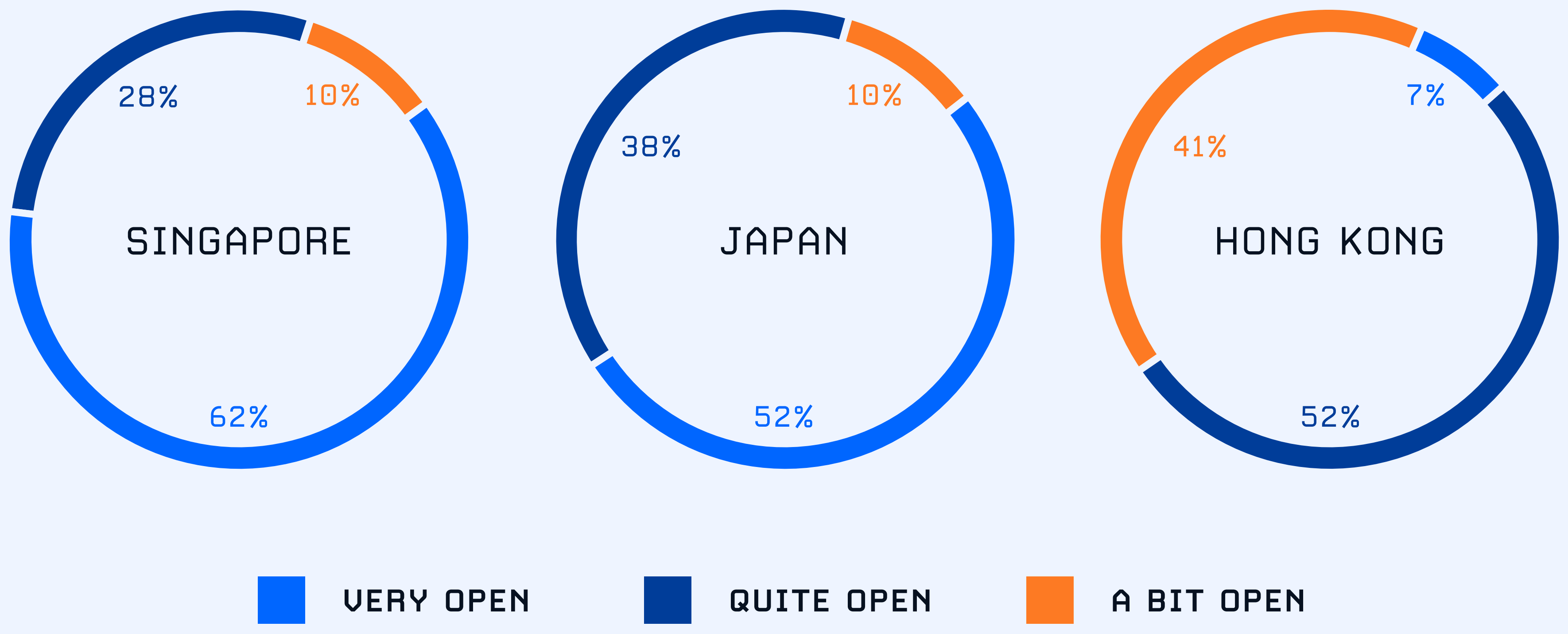
“The culture in Hong Kong OTC derivatives is that people try to keep things unchanged because the senior person is afraid of doing something wrong and this may crash the business.”

There were very high levels of openness to innovation in the UK, with 60% of respondents describing the buyside as very open; while the remaining 40% say they are quite open to new processes.

The picture was more mixed across the EU but with generally high levels of openness to new processes.

ARE YOUR BUYSIDE PARTNERS OPEN TO NEW PROCESSES TO MAKE TRADING OTC DERIVATIVES EASIER?

ASIA



The pace of progress

Market participants must build on the technological progress already made and overcome perceptions that institutions on both the buyside and sell-sides can be sluggish and resistant to change and are prone to taking an "if it's not broke, don't fix it" approach.

Innovation will be essential in improving transparency, particularly on pricing if both sides are to achieve best execution.

One banking respondent said: "We need more automation definitely around speeding up settlements, data processing, even to improve communication between buyside and sell-side."

The buyside is also seeking more innovation to support the use of swaps in new asset classes and strategies, particularly those associated with sustainable investment.

One buyside respondent working in treasury, said: "Our risk has diversified to new products, new areas, particularly in ESG in instruments like green bonds. We ask our banks; how can we hedge those against inflation? We are looking for innovation."

Survey participants also expressed interest in unified information systems fuelled by real-time, reliable data, supported by AI and machine learning.

> There isn't a central location for trade information to disseminate. I would like to see more trade information in one place where all the banks can post their trades for people to see.
>
> ASSET MANAGER, US

CHAPTER TWO

Laying the foundations for high-functioning markets

OTC derivative market participants are largely confident that their sector is functioning effectively, but more tools are needed; particularly in the APAC region and for those using complex instruments, where a growth in independent indices would be beneficial.

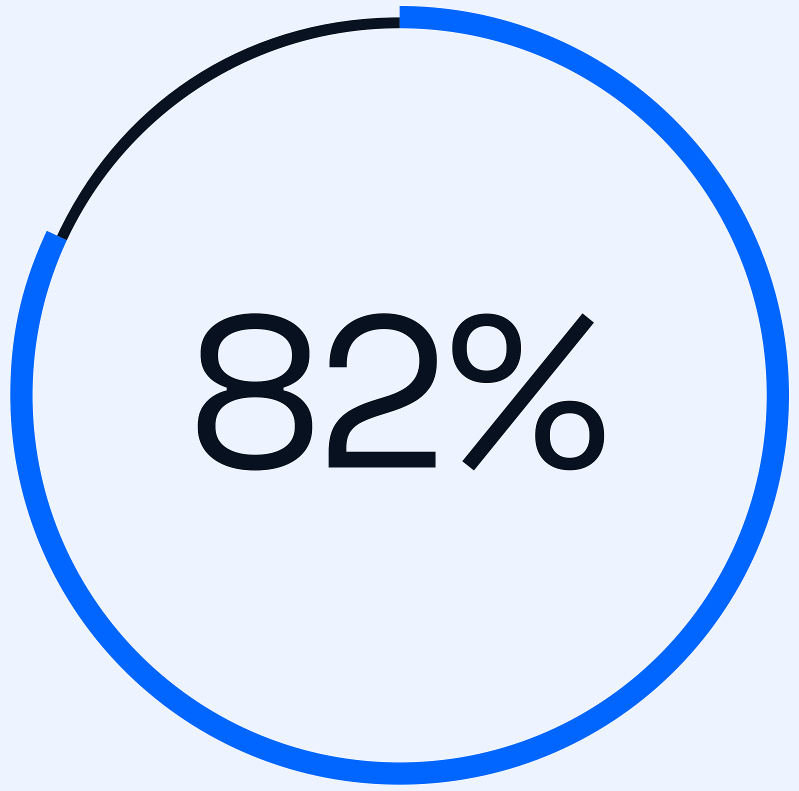
As the markets expand to new participants and evolve to include more complex instruments, they need the requisite foundations – robust data and effective technology – on which to function effectively.

At the same time, centralised data platforms offering market analysis would benefit the OTC market by introducing greater transparency and enhanced risk management. In particular, respondents identify the possible advantages of unified information systems that provide tailor-made news about positions to inform OTC derivatives trading decisions.

Having access to accurate in-depth OTC market data is also essential. Respondents to the survey express a need for more data; particularly in the APAC region, with 26% of respondents from Hong Kong say there is not enough high-quality data to support pre-trading reporting, and for those covering more exotic assets.

And while nearly all (93%) banks agree there is enough high-quality data from places to support reporting requirements and workflows, the same is not uniformly true for the buyside, with one fifth of hedge funds, for example, feeling under-served.

Expanding indices



82% of respondents say more indices are needed

While some respondents believe they are well served by existing indices, this view is not universal; and the buyside are keen to see additional benchmarks to help support their operations.

Overall, 82% of respondents say more indices are needed. With above-average demand coming from banks (86%) and investment companies (88%), this may well be because indices help drive diversification and therefore trading activity, as well as improving hedging and risk management.

While the UK and the US feel better served in the indices the same is not true of the APAC region.

A buyside trader in Hong Kong says: “The OTC market is not very famous or widespread. Some of the traders who have been operating in Hong Kong for many years have never been involved in the OTC market.”

Feedback from the buyside also suggested that operating in APAC can be challenging due to the limited number of available indices.

“Everybody is based around the main indices but there is demand for something that’s more niche because the liquidity is not there. If we were to have a view on Japanese mid-cap or small-to-mid-cap markets in the southern Japanese area, there’s simply no way to really implement that view. So, anything that deviates from the big indices is trickier to implement.”

There is certainly more room in the market for indices that cover more exotic derivative instruments.

INVESTMENT MANAGER, EUROPE

Advancing AI innovation with enhanced data

The rise of artificial intelligence (AI) is already transforming how OTC market participants operate. From algorithmic trading and predictive analytics to risk management, compliance, and trade execution, AI is empowering participants with a powerful set of tools.

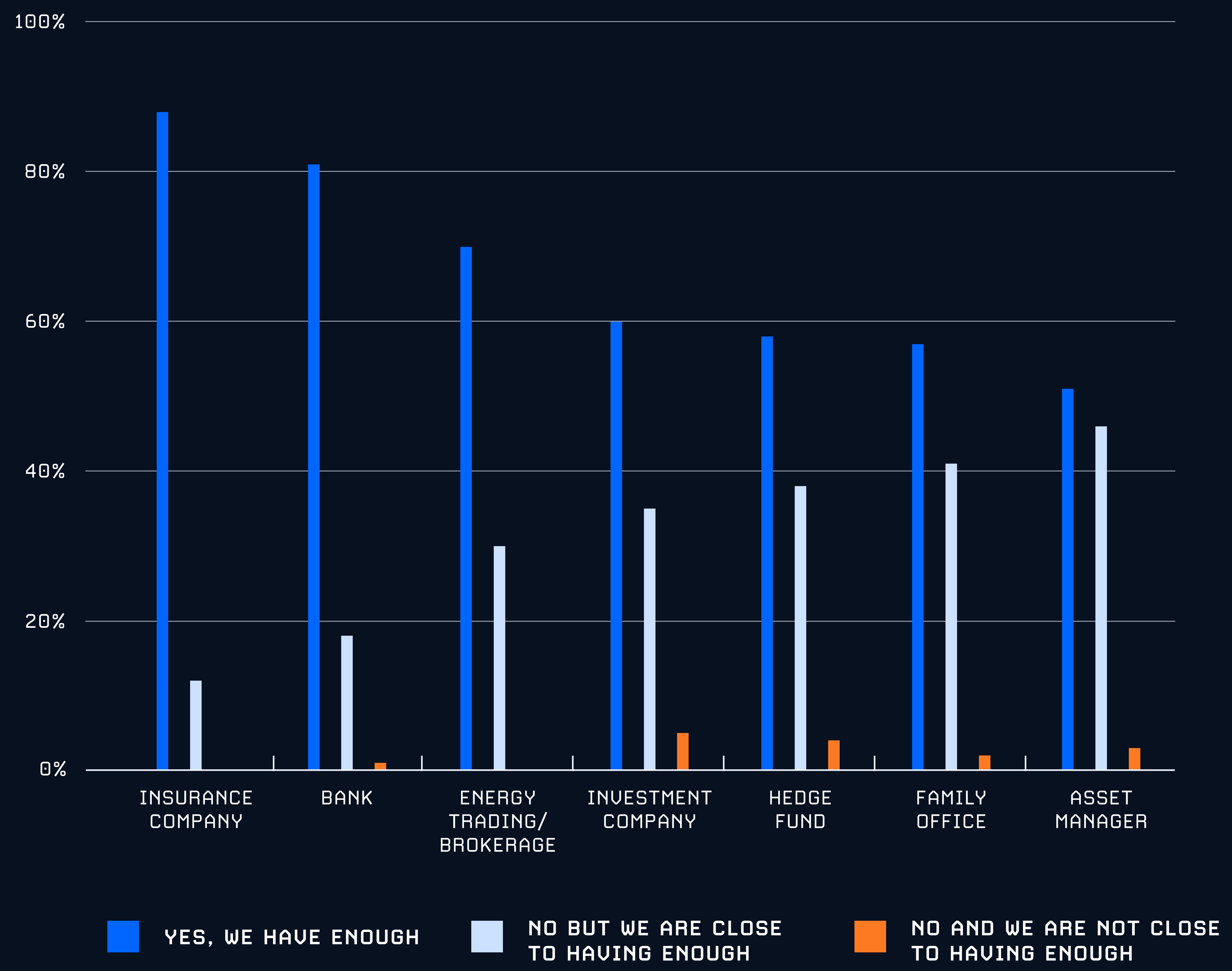
AI-powered algorithms analyse vast amounts of data to identify trading opportunities, forecast market trends, and optimise execution strategies. Machine learning models assess and mitigate risks, ensuring adherence to regulations and protecting against market volatility. AI-driven surveillance systems continuously monitor communications and transactions, detecting suspicious activity and safeguarding market integrity.

By leveraging AI, OTC market participants can gain a competitive edge, improve efficiency, and navigate the evolving financial landscape with greater confidence.

Despite AI already being used extensively across the OTC markets in the above use cases, when looking at developments in AI and automation, more than one quarter (28%) of respondents say there is not enough data to optimise advances in this field.

Banks show relatively high levels of confidence in data to support AI and automation, with 81% of respondents saying they have enough.

AI AND AUTOMATION ARE EXPECTED TO TRANSFORM OTC DERIVATIVES, DO YOU HAVE ENOUGH DATA TO OPTIMISE THESE ADVANCES?



Future-proofing OTC markets

Automation would definitely help with speeding up settlements, data processing, and even communication between buyside and sell-side. Technology brings continuous improvements in terms of efficiency.

BUYSIDE RESPONDENT, UK

While data is one of the essential foundations on which OTC derivatives markets operate, that data requires the correct skills to interpret and correctly use it.

One buyside respondent says: "When you look at hedge funds and the jobs on the equity derivatives desk, the description used to be 'do you have experience at a sell-side bank because we haven't traded derivatives before, and we need somebody that knows how to do it'. Now it's the need for a PhD in quantitative finance or a PhD in coding."

Overall, 88% of respondents say they have enough internal knowledge to analyse and interpret the data to their advantage. As in other questions, APAC respondents were less confident than those in the rest of the world. Asset managers appear to have the most internal capability, with 95% saying they can use data to inform processes in-house.

Meanwhile, 91% of sell-side respondents say they are internally equipped to use data to their advantage.

Where firms felt that they lack internal expertise, they are more likely to hire new staff to plug knowledge gaps than expend budgets on training existing employees.

AI could help my role in terms of 'know your customer' (KYC). It could help make regulatory compliance faster, as well as responding more quickly to clients and managing certain queries. There could be a time when everyone has an AI assistant.

BANK, GERMANY

CHAPTER THREE

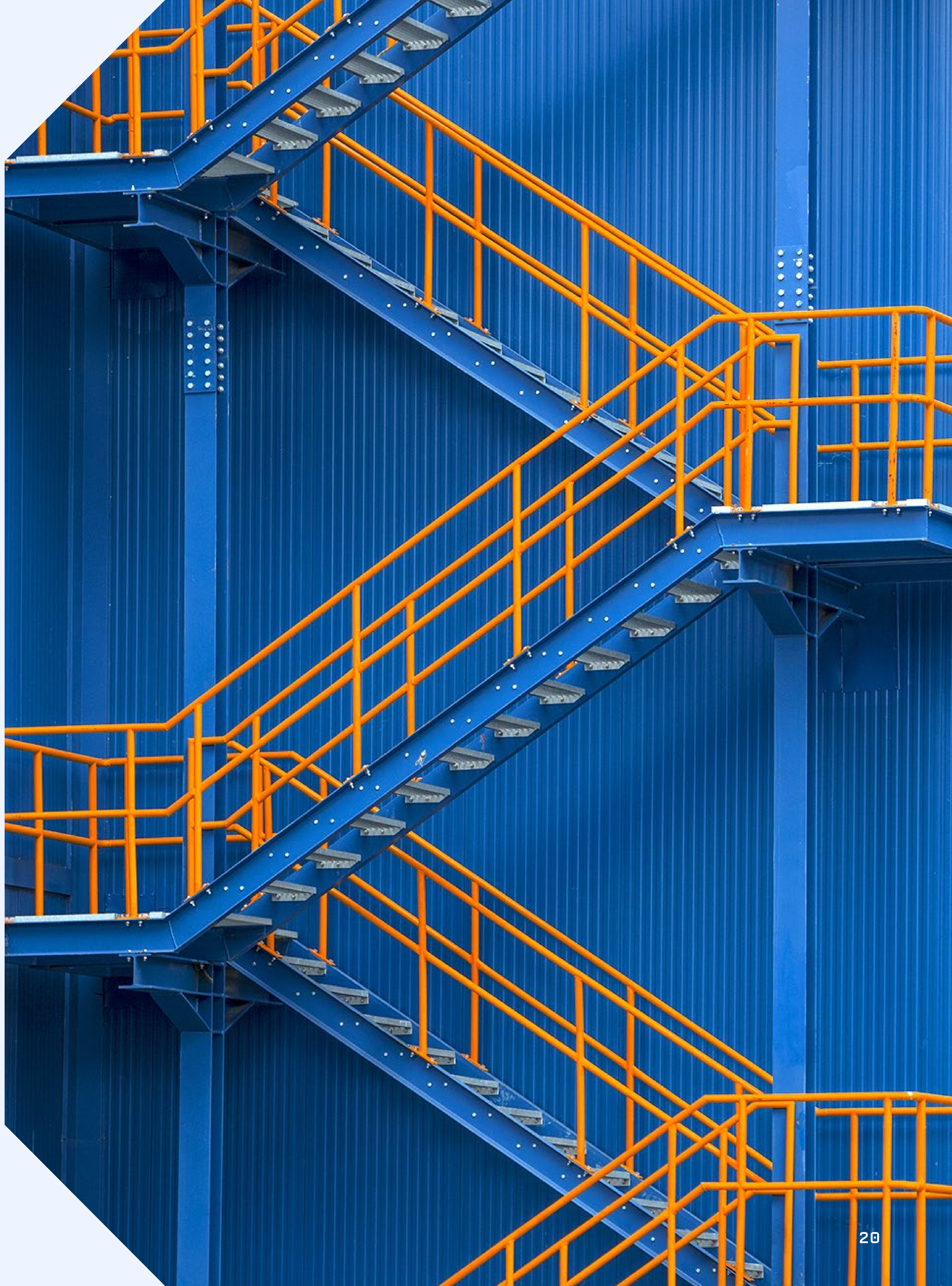
Balancing risk and opportunity

The growth in central counterparties (CCPs) following regulation brought in after the financial crisis has improved security for the OTC markets – but with that stability comes greater liquidity constraints.

During flight-to-safety episodes such as during the global financial crisis or in times of geopolitical turmoil, as we have seen in recent years, some CCPs may place more cash with central banks rather than recycling it through reverse repos, thus removing liquid resources when they are in high demand.

The recent rising interest rate environment has also added to the liquidity concerns, particularly for asset managers working with smaller or mid-tier banks.

One respondent told us: "Banks' balance sheets are not as good as they were when the interest rates were so low. You have less funding on the market for less credited banks. We are working with a lot of medium-sized banks as well and the liquidity is not as good as it used to be."



Liquidity is a universal concern for market participants and nearly all (94%) respondents are more concerned about liquidity than they were three years ago. There are several reasons this is the case.

01

First, limited liquidity can trigger significant price swings even from small trades, leading to volatility.

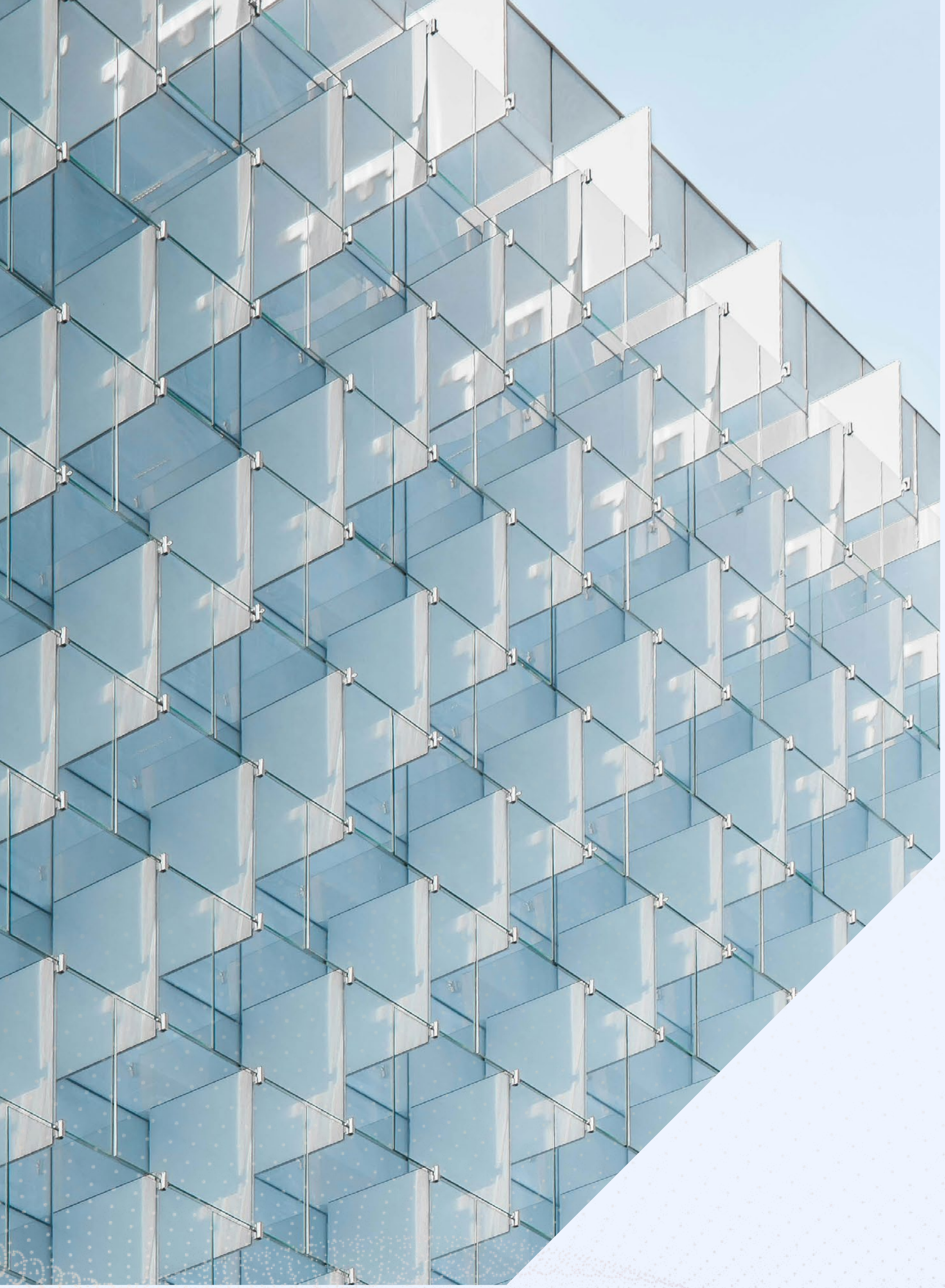
02

Second, executing trades, especially large orders, becomes challenging due to delays or a lack of counterparties willing to transact at desired prices. This "execution risk" is further amplified by the potential for large trades to substantially impact prices in illiquid markets. Further, managing risk and hedging become difficult as efficiently entering and exiting positions is hampered. This translates to increased operational and financial risks.

03

Finally, the bilateral nature of OTC transactions elevates counterparty risk, as limited liquidity exposes traders more to the creditworthiness of their counterparts. In essence, concerns about liquidity centre around its impact on price stability, execution efficiency, risk management, and counterparty risk, underlining its critical role in ensuring a well-functioning and confidence-inspiring OTC market.

Respondents to our survey are clear that liquidity is more of an issue now compared to three and five years ago, largely as a result of rising interest rates which has caused a lower market value of liquidity portfolios.
If these liquidity issues are not managed appropriately, they can cause problems during periods of market stress – as we saw in the UK gilt crisis of 2022.



Enhancing transparency

Regulation has helped shine a light on the OTC markets and improved transparency, but market participants say they need more help from data to inform algorithms and models, identify trading opportunities and assess risk.

Buyside respondents say they are too reliant on the sell-side for information, and they are looking for open and accountable providers offering transparent methodologies, rather than simply delivering black box numbers.

A buyside respondent said: “More technology would be useful in terms of understanding where the quotes are from or even an understanding about what the liquidity is or depth of the market. Just give me the answer.”

Another buyside respondent said: “The only real source of liquidity is your network. You are either speaking to a bank, or a broker. It’s not like you can go onto a Bloomberg screen and see the list of market or anything like that. So, the transparency of that market is quite poor as a result.”

Supporting the AI transition

There is no doubt that AI will have a major role in shaping the OTC derivatives markets.

The International Swaps and Derivatives Association says the ability to process vast amounts of unstructured information to identify patterns and insights could bring "enormous efficiencies and savings in the years to come".[2] But given some of the survey respondents' misgivings about the lack of data to support AI and automation in markets, they are concerned the industry will not manage a transition to artificial intelligence without incurring additional risk if the technology is not applied competently.

While the majority (87%) say they are confident there is enough data to support AI and automation, the number dipped when looking specifically at some respondents from the buyside.

ARE YOU CONFIDENT THE DATA IS AVAILABLE **TO SUPPORT A TRANSITION TO AI?**

75%

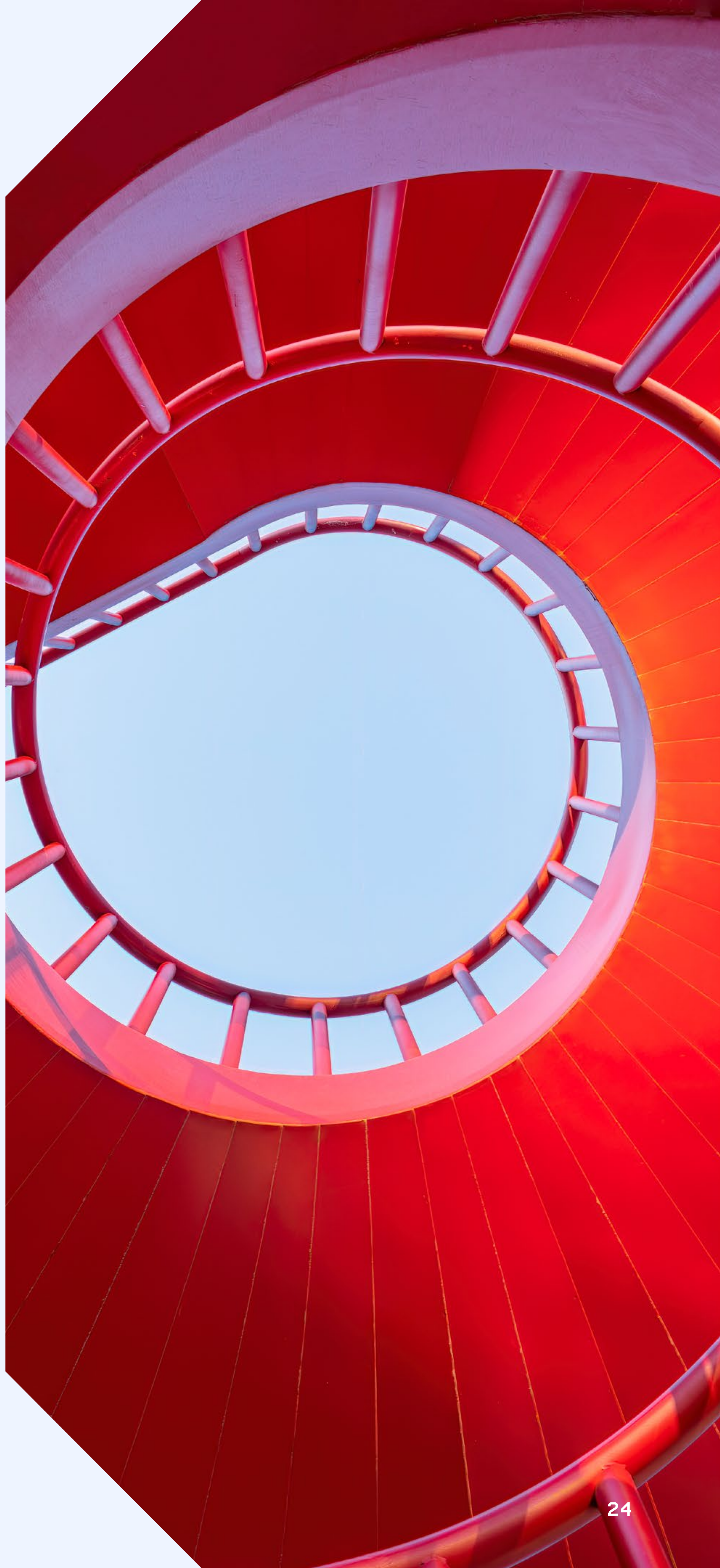
OF HEDGE FUNDS ARE CONFIDENT

Evolving the OTC markets

OTC derivatives markets have shown willingness to embrace new technology and participants appreciate the opportunities from implementing the very latest in AI and machine learning to improve processes and to direct human resources to more profit-generating tasks.

Yet, for that transformation to manifest, our research suggests there needs to be an acceptance of the associated risks. For some firms – particularly those on the sell-side – only when they fully understand the risks, with the help of reliable market data, will the OTC market move to the next stage.

> We don't like to shift something which is already working to something which might have error in it. Moving to an AI platform could be a really big risk for us.
>
> BANKER, FIXED INCOME, EUROPE



Conclusion: Driving market functionality with enhanced data

OTC derivatives markets are expanding rapidly and the buy and sell-side need to adapt, automate and embrace technology – especially AI – to ensure they continue to deliver enhanced execution.

All the participants of our market survey recognised there was a need for greater levels of communication, cooperation and collaboration if they are to improve market functionality.

Underpinning success is access to deeper pools of reliable data which will inform trading, improved transparency and helping overcome the ongoing liquidity challenges.

As a consequence of our research, we identify five themes that respondents believe would improve the OTC derivative market.

WE'LL EXPLORE THESE THEMES IN MORE DEPTH OVER THE COMING MONTHS.

01 Enhanced access to reliable, in-depth data sources from trusted independent sources.

02 More indices to support the greater range of OTC market instruments.

03 Greater market analytics to bring improved transparency and to better understand liquidity.

04 Greater communication between the buy and sell-sides on where automation and execution improvement are needed.

05 Greater education and training on the benefits and implementation of technology, specifically AI and automation.

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