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# Adapting to the New Realities of Capital Markets Trading



**Prior to COVID-19's onset, some capital markets firms were struggling to adapt to rapid changes in their trading businesses. As the pandemic has progressed, we've seen an acceleration in existing challenges and the sudden onset of new ones. Both demanded a solution—yesterday.**

**As a result, many capital markets firms find themselves completely re-thinking the trading business, from digitizing trade execution and trader collaboration, to the technologies needed to compete effectively, and to the kind of experience that clients want, inside and outside of a pandemic.**



COVID-19-induced volatility has added a new wrinkle to trading operations. Although many firms have exited trading, big banks that have maintained such operations have experienced a surge in volume and profitability in this area. Investment banking and trading revenues hit an eight-year high in the first half of 2020, with fixed income trading alone rising 56% from 1H 2019 to 1H 2020.<sup>1</sup> For some banks, these revenues have helped offset losses and provisions for bad credit in other parts of the business—accounting for over 70% of second quarter’s revenues at select players.<sup>2</sup>

This represents a partial reversal of a trend we have seen since 2008. Over that time, investment banks’ trading operations have largely underperformed in terms of profitability, leading to questions around its viability, necessity and longevity. Despite these solid results seen by some banks in the first half of 2020, we believe that many banks’ current trading operations models are not well-suited to keep up with rapid change.

Why? Simply because the core fundamentals are under threat. Maintaining regulatory compliance has consumed cost and capital. Margins on trading traditional products have narrowed, while risky trading strategies are no longer in favor. Technology adoption has been mostly fragmented and inconsistent. The competitive landscape has changed as well. Buy-side clients are no longer content to work with a single partner; instead, they look for better prices and increased services.

Underpinning all of these challenges is a need to manage an unprecedented and ongoing evolution in the nature of trading itself, as technology emerged as a means to preserve the culture while reinventing the business. Previously rigid, partially digitized and unflinchingly regulated, it’s now defined by a new paradigm of remote connectivity, collaboration and compliance—while keeping clients at its very core.

**Adopting to this new shift requires a nimble framework blending hard applications (as a technology-driven efficiency play) with softer tools (designed to provide for the employee experience). Based on discussions with our clients, and what we've been hearing in the market, we've identified five key challenges affecting the future of trading:**



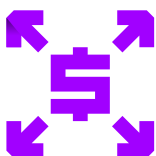
### **1. Managing volatility and uncertainty**

Ongoing volatility increases the risk of unexpected losses, cushioned to some degree by high trading volumes. This is potentially magnified by the challenges of a remote workforce.



### **2. Facing commoditization**

Decreasing brand differentiation via an echo chamber and increasing automation reduce margin opportunities.



### **3. Cutting costs**

An ever-increasing regulatory burden, along with longstanding front- and back-office inefficiencies, is further increasing costs.



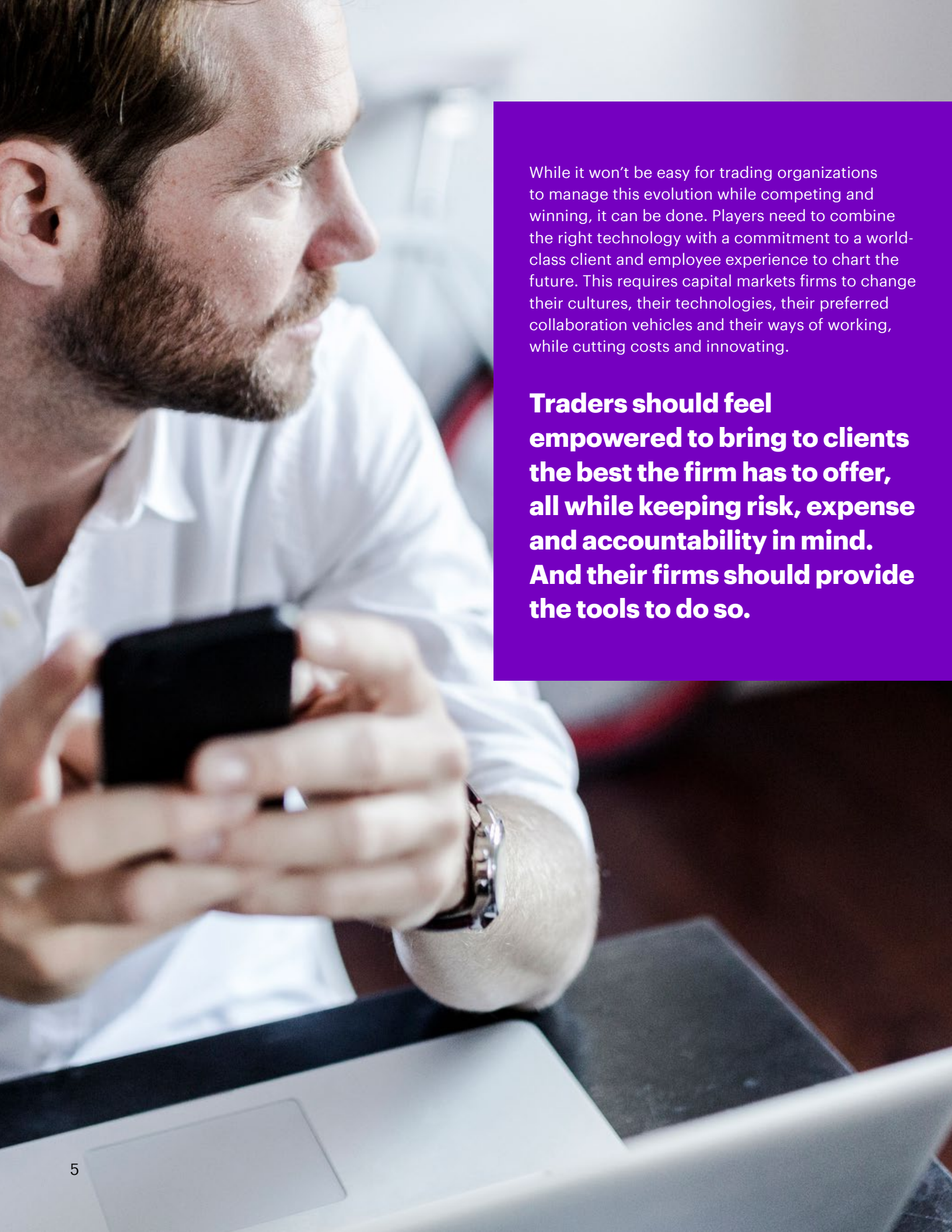
### **4. Responding to evolving client demands**

Clients demand more data, services and regionalization, among other requests, from the firms they work with—thereby creating new layers of complexity.



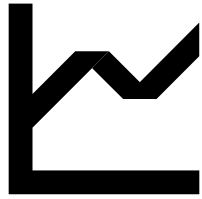
### **5. Delivering innovation**

The rapid pace of technology adoption further distances the leaders and laggards.



While it won't be easy for trading organizations to manage this evolution while competing and winning, it can be done. Players need to combine the right technology with a commitment to a world-class client and employee experience to chart the future. This requires capital markets firms to change their cultures, their technologies, their preferred collaboration vehicles and their ways of working, while cutting costs and innovating.

**Traders should feel empowered to bring to clients the best the firm has to offer, all while keeping risk, expense and accountability in mind. And their firms should provide the tools to do so.**



# Managing volatility and uncertainty: business as usual while working remotely

The pandemic continues to challenge capital markets firms across the board. Trading organizations found themselves handling high volumes with teams that had been pushed—with little preparation—into remote locations, often working “virtually” from home. Players responded well: 11 out of the 13 tracked banks booked a year-over-year increase in total trading revenues and eight out of the 13 recorded higher revenues in the second quarter than in the first quarter.<sup>3</sup>

Rightly so, firms were pleased with their ability to operate in this manner, but over time, cracks emerged between results and the very nature of trading itself.

Our conversations with traders at major banks indicate some of the stresses of working remotely. One trader told us, for example, that “... people will want to work from home, and firms will demand it ...” but others noted concerns about the ability to protect sensitive information in a remote world; the difficulty of maintaining client relationships in the absence of face-to-face contact; decreased productivity due to technical issues; and,

most significantly, the absence of camaraderie, shared culture and shared information fostered by the trading floor environment. This latter point is key, as the so-called incidental information exchange is difficult to replicate virtually.<sup>4</sup>

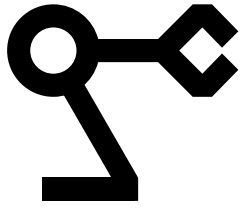
This is natural and expected. As an industry, we’ve moved past the adjustment phase (executing quickly to maintain business as usual), acceptance phase (from the new normal to normal) to the questioning phase (how else can the firm help the trader remotely and virtually).



As a result, we see three new technology offerings (“three C’s”) emerge, uniquely aligned to the trader of the future’s unique needs:

- **Connection technology:** Tools that keep conversations flowing naturally and easily, mirroring background trade floor chatter and workplace experience. This segment is defined by apps or devices that provide the user with human voices and extemporaneous conversation in the background, instead of face-to-face on a previously scheduled video call.
- **Collaboration technology:** Products that allow traders to replicate the experience of strategizing in the same room and at the same time. This is evolving beyond audio and video improvements—these tools marry the physical and digital via XR (Extended Reality) and related immersive experiences that make the digital, personal.
- **Compliance technology:** Offerings that provide the related regulation of communications and physical compliance aspects like mobile device distancing from the trader’s workspace or phone calls made on unmonitored lines. These tools provide the required level of regulatory and compliance management, bridging the gap between physical workplace transparency.

The first two C’s offer communication tools or plugins to facilitate casual conversations and exchanges of information between virtual and on-site employees—the kind that normally occur on the trading floor. We also call this “Tap on the shoulder”: a conceptual digital voice and video communication tool that aims to virtually mimic casual gatherings on trading floors. By looking at a digital version of the floor map and being able to see where people are in real time, employees can find and virtually “tap” on other people on the map to start a conversation from their device. We also recommend exploring avatar usage and other XR tools that cut across disparate real estate locations.



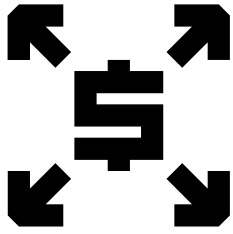
# Facing commoditization: increasing complexity in light of lower revenues

**Increasing complexity is transforming the trading business. For example, as institutions have greater liquidity demands—the largest players held \$1.3 trillion in common equity and \$2.9 trillion in high quality liquid assets in March 2020—total fees are down.<sup>5</sup> Additionally, there has been extensive growth in alternative assets such as commodities and derivatives, which have their own trading characteristics and technology requirements.**

Firms are engaged in an arms race, acquiring technology that might influence alpha and provide a point of differentiation. They compete against, but also collaborate with, fintech companies that regularly disrupt established businesses and drain previously lucrative profit pools. Similarly, firms are awash in data, but there is little consensus as to how that data should be used. Data capabilities are often used as point solutions rather than as core elements for providing strategic direction to management and, ultimately, for creating value.

We believe that designing the successful trading organization of the future calls for a new vision, one based on lessons learned by big technology companies as they out-innovated, out-marketed and generally outflanked their competitors by keeping data at its core. Capital markets firms should look to the West, where Silicon Valley has developed and cultivated talent with an innate ability to separate signal from noise. They should continue blurring the lines between technologist and business strategists as both halves work as a whole.





# Cutting costs: effectively, efficiently and necessarily

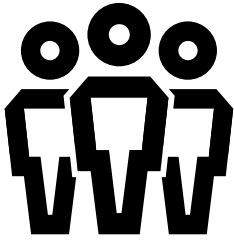
**According to Accenture’s Return to Work Survey, 61% of Financial Services CIO/COO respondents don’t expect all of their remote workforce to be called back to the office. In light of these developments, firms are taking a hard look at their fixed cost base and assessing the structure in light of newer, safer and preferred ways of working. As these reviews continue, it’s critical that firms maintain their unique culture and fabric.**

Firms should establish effective communications between remote and in-office employees, especially when it comes to explaining how the company would enforce safety guidelines on the trading floor. The trading floor itself needs not only the technology but the physical design to support a safe, positive experience for workers—taking both mental and physical health into consideration.

We see two cost levers emerging. For example, as the real estate footprint cost may decrease, there’s an inverse increase in the other cost lever for items such as partitions, cleaning, spacing mandates and temperature checks to keep employees safe and healthy.

This highlights just one aspect of increasing costs in light of declining revenues. There is also the gradual electrification of markets to manage. For example, as fixed income trading becomes much more digital (and changes the >\$100 trillion world of sovereign and corporate debt in the process) we expect a similar democratization across the trading value chain and infrastructure—one that’s cloud-based and accessible in real-time.<sup>6</sup> Firms should try to secure a competitive edge by fully automating and digitizing corresponding functions.

As the operating model is further digitized to reduce costs, it’s important that firms seize the opportunity to right-size their cost structure, while, at the same time, making it future-proof. Delivered together, it’s a story of core business tenets combined with strategic aspirations—one that’s ready tomorrow, today.



# Responding to evolving client demands: introducing the Trading Squad

A key element of our vision of the Future of Trading is what we call “The Trading Squad”: a client-focused group that emulates some core Big Tech practices, such as:

- **Client obsession:** A commitment to delivering the best experiences to high value clients, in line with their needs.
- **Human + machine:** Technology-based trading with cutting-edge capabilities and services across points of the client lifecycle.
- **One team, one experience:** Continuous innovation, from front-office to back-office, driven by an owner/operator mindset.
- **Endless trading floor:** Seamless trading services conducted from central, remote and virtual environments.
- **Operational signals:** Operational data cultivated and used to develop an edge in trading along with a better client experience.

The Trading Squad is designed to manage the client experience autonomously, selecting the right services for the right moment. It conducts constant experimentation and innovation to reflect client needs—but embraces ways of working and an employee experience grounded in an ownership culture.

In the Trading Squad model, individual teams have incentives to manage risks and costs. While business teams take responsibility for compliance and technology concerns, they are freed from non-core functions through technology or by arbitraging the skills of partner organizations.

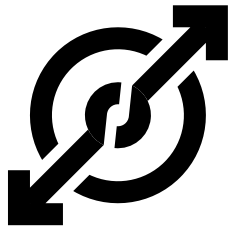
Trading Squads identify and prioritize the needs of high-value clients, then define the tools, products and services needed to manage the customer experience to build loyalty and accelerate growth. Data and technology services are selected on-demand to support the desired experience.

Squads use a robust, flexible technology toolkit to create new services. Where there are gaps, they use partner capabilities as needed. And Squads are connected to a virtual internal experience to provide consistency and collaborations, engaging the right support functions at the right moment.

The Trading Squad model can, in our view, help firms realize gains on both the revenue side and the expense side of the ledger. On the revenue side, better coverage and closer attention to client needs leads to increased client loyalty and more opportunities to conduct high-value trades. There is greater latitude to charge fees for premium client services and experiences, along with potential fees for data-as-a-service and modular and/or bundled packages of insights.

On the expense side, labor and technology arbitrage achieved through the construction of a digitally enhanced, cross-functional team can reduce both transaction and non-transaction costs, while better data and deeper insights can lower provisions for credit losses. Firm-wide, greater ownership of, and accountability for risk management can improve returns from new and existing trade positions, leading to a higher risk adjusted rate of return on capital (RAROC). The model delivers the best of both worlds: clients enjoy a higher touch model, firms leverage existing talent pools and employees are offered the opportunity to work together in new and exciting ways.





# Delivering innovation: defining the client experience of the future

Reorganization via the Trading Squad concept and reinvention via a new approach to the trading floor are essential elements for firms seeking to adapt to the new trading environment. We see this manifested in the redefinition of the trading client experience, one that's defined by ongoing innovation and commitment to new ways of working.

The building blocks of the new client experience include:

**True client partner.** Firms should commit to providing best-in-class investment management as a service, helping clients build data and technology trading cycles to enhance efficiency, risk management and trade optimization. This entails shifting core trading operations to a platform-enabled business to maximize the impact of the ecosystem, adopting a new mindset for value creation and adding value across the lifecycle. The platform supports a collaborative exchange of data, assets and skills, measuring success through ecosystem value and network effects.

**Everything is tradeable.** Firms should offer investors innovative new financial products and services from alternative asset classes to provide them with greater choice and portfolio diversity. This may mean creating investment and funding opportunities in illiquid assets or private markets, or in new asset classes such as art securities, emerging technology ETFs, and private market futures. Digital and crypto-assets—though in their infancy—already offer returns, with many more use cases under development. In fact, there's over \$7.8 billion locked up in smart contracts for decentralized finance applications as of early September.<sup>7</sup>

**Democratization of finance.** Trading organizations can broaden access to financial markets by delivering greater transparency into fees and pricing, reduced intermediary costs and outcome-focused strategies to help redefine what it means to be a fiduciary. Passive funds have already changed the outlook for investing, creating low-cost opportunities for new investors to participate in the market.



Today's digitally enabled customers expect more data and clear messaging from fiduciaries, with increased financial literacy across entry-level investors driving a shift toward true advisory rather than intermediary fees.

**Platform business plays.** Digital products, channels and marketplaces can aggregate data, service providers and consumers to create network effects. To accomplish this, firms can shift the role of the salesperson to spend more time with the clients and less time on data analysis (which can be managed by AI). Freed from manual processing, portfolio managers, analysts and brokers would have more time to generate ideas and work with their clients.

**Electronic market-making.** Electronic trading and data exchange can serve as the basis for new digital marketplaces and value chains, driving more liquidity, diversification, trading volume and market depth. Automated market making decreases volatility and improves cost optimization, and, as equities marketplaces become deeper and more transparent, markets become more service-rich and provide platforms for greater access and innovation. It's the perfect combination of technology augmenting, not replacing, the trader's voice.



## What to do next

Moving forward requires a hard and honest look at the current cost base, client feedback, revenues and the competition. Part of such a strategic assessment calls for a thorough review of which operating changes have added value, which have created risk and which have diluted value. Successful initiatives should be made permanent, if possible, and trading organizations should analyze these inputs to learn from gains, minimize waste and build resilience.

But this is also a time to be bold, to set ambitious targets for the future, to solve inefficiencies and open new paths for growth. In difficult economic conditions, traders would need to imaginatively manage their own costs as well as their clients' costs. Volumes would be unpredictable, and competition for trade flow is expected to be fierce.

**A slight edge in operational efficiency and effectiveness will likely weigh disproportionately in this environment, making it essential to plan now to design the trading organization of the future.**

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