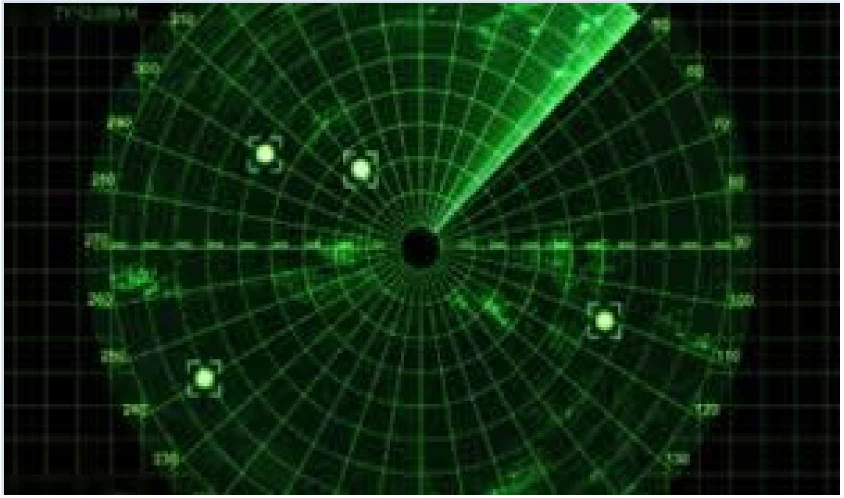

Union Investment

Regulation and Electronification – A Paradigm Shift in Fixed Income Markets

Frank Engels
Frankfurt am Main
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The Regulatory Environment – A Game Changer for Fixed Income Markets

Regulation leads to lower profits of sell-side industry and results in lower liquidity in fixed income markets

Dodd-Frank (Volcker Rule)

Ban of Proprietary Trading

Basel III

Additional RWA (Risk Weighted Assets)-Charges

MiFID II

Pre-/ Post-Trade Transparency; Definition of Liquidity

- Higher cost and lesser opportunities to generate profits lead on average to lower profitability for sell-side firms (cost-income ratio of 55-65% in fixed income and FX versus 90-110% in equities)
- Results in:
  - Less capital committment from sell-side
  - Withdrawal of sell-side firms from certain business areas
  - Lower liquidity in markets

Change of Market Structure and of Role of Market Players

Shift in tradition roles between buy-side, sell-side and market places due to effects of regulation

Sell-Side	• Liquidity provider, price maker • Committment of principal capital • Trading in „one clip“	→	• Reduced function as liquidity provider • In liquid products shift towards agency business with „working orders“
Buy-Side	• Consumer of liquidity • Price taker	→	• Ongoing liquidity taker • But also price maker • Trading against buy-side directly • Active use of algos in CLOB-style venues
Venues	• Most of the business still based on RFQ-model • Venues predominantly just , „dealer-to-customer“ or „dealer-to-dealer“	→	• Further electronification leads to more fragmentation and equity-style venues • More use of „all-to-all“ venues

Fragmentation in Fixed Income Markets as a Result of Shift towards more Electronic Business

Electronification reduces dominance of RFQ-protocols and creates new opportunities for vendors in equity-style platforms

Types of Electronic Platforms

Information only

- Management of broker axes and inventory (i.e. Neptune, Algomi)

Trading/ Execution

- RFQ (i.e. Bloomberg TSOX, MarketAxess, Tradeweb)
- OTC
- Crossing Network (i.e. MarketAxess Open Trading, Bloomberg BBX, Liquidnet)
- CLOB (TradingScreen, MTS/ B2Scan, Deutsche Boerse, Euronext)
- Market Making/ Auctions (i.e. IDB's like Tullett Prebon, ICAP, BGC)

Electronic Credit Trading: Rising from low levels

Higher importance of electronic trading in Europe/Eurozone relative to the US

- **Market share** estimated to range between 14 and 18%
- Some platforms (e.g. Market Axess, Bloomberg) report current share at about 25% of turnover
- Corporate credit markets remain **highly heterogenous** (average S&P500 corporate has 12 bonds outstanding)
- Only 34% of all US HG bonds trade once a week

- **Market share** higher than in the US, ie. currently at around 25-30% even though the European credit market is even less liquid than the US
- **Leading buy-side firms have been able to expand electronic credit trading to about 60%** of all flows using multi-dealer RFQs and crossing systems

- Most of credit e-trading takes place via multi-dealer or single-dealer RFQ platforms
- CLOBs and crossing systems have yet to grow in importance (< 5 percent of flows)
- Lack of standardisation (instrument heterogeneity) is seen as major impediment to e-trading in credits
- E-Trading is seen unlikely to improve liquidity in tail events

Sources: Oliver Wyman & Morgan Stanley, 2015; McKinsey & Greenwich Associates, 2013; Union Investment, 2015.

Electronic Platforms like CLOB‘s allow Electronic Liquidity Providers (ELP‘s) Access into Fixed Income

A learning lesson from equities is that ELP‘s – some might call them High Frequency Traders – are not bad for markets by default

Automated Market Makers (+)

- Considerably more passive messages than aggressive
- Provide greater liquidity in markets where there is less toxicity
- Profit from spread of products
- Accepted by most market participants to be beneficial to markets

Latency Arbitragers (-)

- Rely on a speed advantage – co-location, FPGA, infrastructure management
- Futures vs. Cash, Platform vs. Platform
- Benefit from different fee models in the market
- Not beneficial to buy-side firms

Short Term Momentum Players (-)

- Short term momentum strategies which search for signals in the market
- Most profitable strategy for HFT
- Sometimes described as front-runners but this is technically not true as front running is illegal
- Not beneficial to buy-side firms

Trading Desk as Service & Solutions Desk moves into a Central Role in Portfolio management

SERVICE & SOLUTIONS

High-touch Trading
(high level of specialisation Because of high complexity, low liquidity, high market impact)

Fixed Income	FX	Cash Equities	Deri-vates
Trader …	Trader …	Trader …	Trader …

Advice for portfolio managers in order execution

- Selection of venues and ISIN's
- Liquidity as key topic
- Market Intelligence (bottom-up, top-down)
- Use of derivates

Electronic (Flow-) Trading
(small market impact only, high liquidity, high level of automatization to fully automized execution)

Fixed Income	FX	Cash Equities	Deri-vates

Trader

Trader

….

Services

Best Execution	Broker Vote	FX Conversion	Axes & Inventory Management
Transaction Cost Ana-lysis (pre-/ post trade)	Broker Contracts	Support in Placements	Reporting / EOD Statistics

Spending in technology is essential to improve the liquidity situation

How to cope with the problem of liquidity going forward?

RFQ

OTC

Crossing Network

CLOB

Market Making, Auction

TCA (pre- and post-trade)

EMS (Execution Management System)

OMS (Order Management System)

Pre-Trade Information

- Change of behavior of market participants to stay “ahead of the curve” in a quickly fundamentally changing landscape
- Improved use of pre-trade information, also better use of post-trade data when available (in Europe for example Trax and consolidated tape, when available; in the US TRACE)
- Change of role of Buy-Side Trader, development towards advisor for portfolio managers
- More “all to all” trading venues, not just traditional model with sell-side as price maker
- Integration of new electronic trading protocols, not just RFQ protocol
- Also discussed is standardization of selected features of newly-issued corporate bonds

Issues for discussion

- Wholesale banks are increasingly retrenching from fixed-income trading (balance sheet reduction of 40% in RWA terms over the last 3 years) against the background of rising regulatory costs.

  1. By how much do we think will the balance sheet allocated to flow FI-trading will shrink in the coming few years?

- Buy-side institutions are increasingly less willing to restrict themselves to price-taking, thereby breaking up the traditional separation of role models in execution (ie dealer-to-client and dealer-to-dealer relationships).

  2. How will this affect the strategy of the broker dealer community going forward, and how will trading profitability be affected on the sell-side?

  3. Will all-to-all platforms increase secondary market liquidity?