Regulation and Electronification – A Paradigm Shift in Fixed Income Markets

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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 commitment 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
- Commitment of principal capital
- Trading in „one clip“

**Buy-Side**
- Consumer of liquidity
- Price taker

**Venues**
- Most of the business still based on RFQ-model
- Venues predominantly just „dealer-to-customer“ or „dealer-to-dealer“

**Sell-Side**
- Reduced function as liquidity provider
- In liquid products shift towards agency business with „working orders“

**Buy-Side**
- Ongoing liquidity taker
- But also price maker
- Trading against buy-side directly
- Active use of algos in CLOB-style venues

**Venues**
- 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

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

<table>
<thead>
<tr>
<th>Automated Market Makers</th>
<th>Latency Arbitragers</th>
<th>Short Term Momentum Players</th>
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<tbody>
<tr>
<td>• Considerably more passive messages than aggressive</td>
<td>• Rely on a speed advantage – co-location, FPGA, infrastructure management</td>
<td>• Short term momentum strategies which search for signals in the market</td>
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<tr>
<td>• Provide greater liquidity in markets where there is less toxicity</td>
<td>• Futures vs. Cash, Platform vs. Platform</td>
<td>• Most profitable strategy for HFT</td>
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<tr>
<td>• Profit from spread of products</td>
<td>• Benefit from different fee models in the market</td>
<td>• Sometimes described as front-runners but this is technically not true as front running is illegal</td>
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<tr>
<td>• Accepted by most market participants to be beneficial to markets</td>
<td>• Not beneficial to buy-side firms</td>
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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
- Derivatives

**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 derivatives

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

- Fixed Income
- FX
- Cash Equities
- Derivatives

**Services**

- Best Execution
- Broker Vote
- FX Conversion
- Axes & Inventory Management
- Transaction Cost Analysis (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?

● 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?