Fixed income electronic trading is growing, so is regulation. Industry experts gathered to tell Lynn Strongin Dodds how they see the market evolving.

Supurna Vedbrat, co-head of e-trading & market infrastructure, BlackRock
Michelle Neal, global co-head of GFI electronic markets & prime services, Nomura International
Steve Hall, head of europe & asia, Tradeweb
Brad Hunt, head of networking & electronic execution, Markit

Lynn: The first question up for discussion revolves around the plethora of regulation coming through the pipeline – Dodd-Frank, European Market Infrastructure Regulation (Emir) and Mifid, just to name a few. What do you think the impact will be?

Supurna: I think that we will see fragmentation of liquidity and reduction in counterparty risk. There will be greater standardisation of products as well as price transparency. Hopefully, when we see final rules on public reporting, they will take into account what the liquidity impact will be on the bid-offer spreads which will widen if that timing is too short. Ultimately, clients will be the ones impacted by widening in spreads as performance returns will be affected.
Steve: Electronic trading is clearly growing and the prospect of regulation has accelerated this trend. The big issue though is that we don’t really know what the final Dodd-Frank rules will be. At the moment, there are consultations taking place on Emir and MiFid II and although everyone is waiting for the next steps, market participants, both on the customer and the dealer side, are already getting ready for change and the new world of clearing. From our asset managers. However, the concern is that the push for greater transparency and reporting of the trading activity could actually compromise their ability to achieve best execution. I agree trades are often done non-competitively and obviously that is going to change. Trying to force things down an exchange-traded model though just doesn’t really work for a lot of the derivatives nor is it in the best interest of the clients.

“I don’t think anybody gets better execution today than the buy-side.”

Brad: It’s still relatively early in the process but the focus is very squarely on e-trading, e-distribution and electronic aggregation of liquidity. While much remains unclear about the end-state for over-the-counter (OTC) trading, many firms are busy building out the foundational infrastructure for e-trading and automated risk management. In equities, the e-trading revolution took over 15 years and substantially altered the market landscape. In fixed income, currency and commodities, there are many similarities, but also substantial differences and these factors will lead us to a different and nuanced place.

A prominent feature of the equities dynamic was intensive client demand to lower transaction costs – this, in turn, drove e-trading adoption and technology spending. I’m not convinced that exists with the same degree of intensity in non-equity asset classes at present.

Supurna, from a BlackRock perspective, are you getting pressure from your clients, or do you think that these changes are primarily motivated by the regulatory aim of reducing systemic risk and increasing safety?

Supurna: We have actually been ahead of the product development and electronic trading curve and I’m glad to say it’s not only regulatory driven but we have put pressure on ourselves to achieve more efficient trade execution and pricing for our clients. The fixed income market is benefiting from the experience in equities over the last 15 years. We do benefit from the electronification of equities and even without regulation, there has been some migration to electronic trading within fixed income. This is because of the efficiencies and improved performance that electronic trading has to offer.

In general, though, regulation is accelerating the change and brings with it greater standardisation. Also, it puts a construct of an all-to-all market where we talk in the context of market participants versus a price taker or a price maker.

Lynn: Steve, what other drivers are you seeing aside from regulation behind the move towards electronic trading?

Steve: Market participants are looking for efficiency and pools of liquidity to access, and they have found electronic trading to be a very effective way of getting that done. E-trading provides pre-trade transparency and execution, whether request for quotation (RFQ) or click to trade and post-trade services.
So, increasingly we work to be part of the customer workflow. There are clearly huge benefits for asset managers who allocate to different sub-accounts.

One question is how much is traded electronically? Each market is at a different stage — in European government bonds, which we’ve been in about 11 years, we think about 50 per cent of the customer to dealer space is now traded electronically.

Lynn: Volume or tickets?

Steve: By volume it’s about 50-55 per cent but the figure is higher for tickets. Breaking it down, by volume, the percentage of the swaps market traded electronically was in single digits and is probably now in the teens – around 15 per cent in Europe and moving that way in the US. And in customer to dealer e-trading of credit, our view is that it was in the low 20s but now is in the high 20s. If you go to credit heads of desks, they think it’s moving to 40-45 per cent.

However, while there is a big shift to electronic trading, candidly, most of the business is still not electronic. Even the most well-established marketplaces still have a long way to grow. We are not naïve enough to think that every cash market will be electronic, but it could be that all standardised derivatives are electronic in the future.

Michelle: We are seeing the same trends but you can come at it from two sides. From a buy-side perspective, electronic trading has had a positive effect on operational efficiency, straight through processing and the ability to demonstrate best execution. These are the key reasons why asset managers, especially the larger ones, have moved to platforms. They want to have the capabilities and be able to achieve economies of scale for the larger transactions with lots of allocations. Smaller managers will use the platforms to access liquidity that they wouldn’t otherwise be exposed to because they don’t really get a good service from the sell-side.

From the sell-side point of view, e-trading was a fast path to promote their liquidity and establish a footprint but the largest banks were also forced to participate. That first leap, though, was not popular and a difficult thing to do.

Supurna: We also need to consider the evolution within electronic trading where an asset class currently resides. In equities, a mature electronic market, you have one stock for a company and it is standardised. In fixed income, trades are generally customised although there has been some standardisation in the credit default swaps market, making it viable for electronic trading. Standardisation and availability of liquidity for these products is fundamental for electronic trading. Over the past decade, we have seen some evolution on the product side that would eventually lead to electronic trading.

Lynn: In terms of other developments, how do you see the debate about a consolidated tape for European Union cash bonds and a Trade Reporting and Compliance Engine (Trace) for OTC derivatives shaping up. Will it be a case that sometimes too much information may be a negative?

Michelle: In terms of the consolidated tape, I have been involved in a number of discussions and again, it’s not a one-size-fits-all sort of situation. In theory, it could be possible with liquid products such as government bonds but in certain credit products, for example, it may be more difficult. You might see something fly across the tape and not see it again for eight or nine months. In other words, there are
narrow and deep markets as well as very broad and shallow markets. That is a major problem.

Steve: One of our concerns is that there needs to be a balance between transparency and liquidity. At this stage, the European Commission hasn’t proposed requirements around the trading protocol, but if regulations are too restrictive, you might have the unintended consequence of forcing a particular protocol, thereby removing customer choice.

Brad: I agree, it’s all about getting the balance right. Even in highly liquid instruments, studies have shown that too much transparency impairs liquidity formation and can increase overall transaction costs. The transparency debate will be critical because it determines the basis under which the market model operates, and within that the incentives to provide liquidity. I’ve always held the view that a healthy and liquid market operates within baseline levels of post-trade transparency to ensure investor protection and allow for diversity of market models. Let’s not forget that the equities market structure evolved from quote-driven or floor-based models to an order-driven market not by regulatory fiat, but through competition.

There will be discussions around calibration and hopefully in Europe there will be some takeaways from the US experiences. What happened in equities, certainly for post-trade reporting, was that the rules were not very specific and it wasn’t clear how they were to be implemented. As a result, people put rules in place before they appreciated how they worked. This created a lot of problems that are now having to be addressed as part of Mifid II.

Lynn: Supurna? What is the buy-side view?

Supurna: We look at transparency from two dimensions – price and liquidity. The proposed regulation is focused more on price than on liquidity. I completely agree with Michelle that whether the markets are narrow and deep, or shallow and broad has to be taken into account when determining timing on when price and trade information dissemination to the public takes place.

We have given recommendations across both credit and rates, on what would be appropriate time intervals for public real-time reporting, based on size of trade and product. I’m cautiously optimistic that we will eventually see something that falls within those limits.

Lynn: Our next focus is on transaction cost analysis and best execution. What impact do you think the regulation will have?

Supurna: Best execution on its own will stay intact because the transaction costs are going to go up for everyone due to regulation. This increase will largely be due to the cost of margin requirements and the connectivity that will be required. Pricing may get impacted. We would like the choice in terms of the number of dealers that we need to go to for best execution price to continue to stay with the asset manager. If, for example, the RFQ minimum of five rule becomes final, then some of the decision making on how to achieve best execution is taken away from the asset manager. We don’t see any benefit to this rule and think it will make best execution harder to achieve. This is because the more market participants know about the trade, the worse the price you are going to get.

Steve: I agree with a lot of what Supurna said. Best execution in Europe is different from best execution in the US, and it may change with Mifid II.”
is different from best execution in the US, and it may change with MiFid II. Best execution is a pretty broad term. It is all about the client fulfilling the policy that each one of them has. We have seen a great deal of interest in electronic trading because you have the information and data around best execution.

Brad: In practice, best execution is more about a process and discipline rather than a formula or a specific rule, because it means different things to different people and has multiple uses. Transaction Cost Analysis is certainly a tool that can be used to facilitate that process, but from experience is far more valuable in facilitating a quantitative process to optimise trade selection and alpha capture.

Michelle: From the sell-side perspective, banks do provide bundled services to their clients which is not just about execution but encompasses things like research and financing. However, unbundling carries the risk that all products and services have to be priced individually and sustainable on a standalone basis.

One result of the changes and proliferation of venues and swap execution facilities is that we are probably going to have to start to look at aggregation technology for clients. I think there are obviously many things to be learnt from the experience in equities and foreign exchange but we have to bear in mind that these markets have different characteristics and a one-size-fits-all strategy doesn’t work and will not produce a good outcome for all the different customers.

Lynn: In general, what lessons do you think can be applied from the experience in equities to other asset classes from an e-trading perspective?

Brad: The main area will be in automation and e-trading, so very technology focused. With the growing popularity in things like cross-asset ETFs and synthetic customised baskets, we are starting to see a lot more cross-asset trading and this is pushing technologies and workflows together in ways not previously contemplated.

The other experience I think firms will want to leverage is with people and skill sets, particularly on the buy-side. These desks are typically now very skilled in quantitative measurement and applying technology to trade automation – so you may even see a bit more cross-pollination of experiences, whether it is equity people moving into fixed income or vice versa.

Supurna: I do agree about the skill set. We are currently in the preliminary stages in fixed income. One of the factors that will define the more quantitative trader or portfolio manager is the type of investment strategies or products that trade electronically and whether they will be high touch or low touch. My experience with our dealer partners in fixed income has been that they are very bright quantitatively and they have already been migrating the best practices from the equity e-trading space.

Lynn: Michelle, on the sell-side, are you applying some of the lessons that have been learnt in equities or is it a completely separate subject in terms of electronic trading?

Michelle: I think it used to be. We are obviously all looking to collaborate and the regulation which crosses equity and fixed income products does help to facilitate that collaboration. You naturally think about how you can adopt best practices, learn from past mistakes and create as many synergies as possible. Our goal is to get as much flexibility, scaleability and industrialisation, for the most sensible underlying cost base on an ongoing basis.

So yes, we are in a position to look at best of breed solutions and turn them into best practice across products. Technology offers the most opportunity to create synergies and efficiencies. That’s going to lead to a sustainable cost base, better pre-tax results for the business and a better service proposition for customers.

Lynn: This concludes our discussion. Thank you all for your time and thoughts.