Electronic trading is driving market structure evolution

Investors and regulators alike are pushing for an exchange-style trading model for credit in an effort to promote transparency and liquidity, as Dominic Holland of Deutsche Bank explains

In the aftermath of the credit crisis electronic markets are starting to see dramatic changes – changes that will have a profound impact on how investment banks distribute their products and services in years to come.

In the credit space there are two main factors driving this change: firstly, the latest developments in the regulatory environment, and secondly, a significant increase in investors’ desire to explore new trading models.

New regulations in eCommerce
The regulatory environment is set to accelerate the use of electronic services by mandating rules to reduce systemic risk, and also significantly increase market transparency.

In the US, for example, the Dodd-Frank legislation will require many over-the-counter (OTC) derivatives to be executed through a ‘Swap Execution Facility’, and thereby will define the price discovery requirements for market participants as well as the timelines for reporting trades.

In Europe, the European Securities and Markets Authority has included electronic trading as part of their recommendations on OTC derivative regulatory reform to the European Commission, by introducing the concept of an ‘Organised Trading Facility’. This will be included in the Commission’s Markets in Financial Instruments Directive (known as MiFID) legislation which also addresses market transparency. The new regulations will include specific requirements for making prices publicly available and ensure trades are reported transparently, whether executed electronically or over the phone.

Although many of the Dodd-Frank and MiFID rules have yet to be finalised, it is clear that electronic execution will play an increasing role in the distribution of OTC products going forward, as they are believed to significantly reduce counterparty risk in the financial system.

Emergence of an exchange-driven model
Over the past few years buy-side clients have been increasingly frustrated at the low level of liquidity offered by traditional market-makers. As a result, multi-asset class managers, with experience of the continual liquidity model offered by the equity markets, have started to demand an exchange style driven model for OTC credit instruments.

Initially the liquidity imbalances were addressed by voice agency brokers, but this has proven to be an expensive model for investors, especially now that market conditions have improved. Institutional investors have a large number of small orders to complete, and believe that other buy-side firms as well as retail clients would be interested in taking the other side of these trades, offering a more competitive quote than the dealer community.

In these surroundings, entities are emerging as potential venues to facilitate exchange trading. Some of the market participants are closely looking at models used in equity, futures, FX and some rates products to find an appropriate solution for credit. The main challenge for market participants is that credit facilitates more instruments than other asset classes (thereby diluting the effect on liquidity).

Furthermore, changing requirements regarding reporting mechanisms seem to drive the potential introduction of an
exchange model as exchanges have robust systems for delivering trade reports to regulators, which could be leveraged for MiFID II.

**Client and dealer initiatives**

To focus the debate, the buy-side have formed several initiatives, for example Cassiopeia – a committee that consulted with around 60 market participants to formulate the “Expression of Needs” framework, which will define how they envisage the operating and organising characteristics, as well as services that a trading platform should follow in order to improve the efficiency of the marketplace.

In addition, some large clients are engaging their leading liquidity providers, such as Deutsche Bank, to discuss how the clients can internalise their own trades and execute unmatched orders with the dealer, or via trading platforms. Clients are increasingly looking at the dealer community to provide them with a robust and scalable electronic infrastructure that allows them to access the financial markets more effectively. As such, banks need to recalibrate their business models by becoming financial service ‘utilities’, providing clients with fully integrated access to the markets through comprehensive electronic trading services.

On the other hand, the dealer community is reacting to the changing environment by investing in technology solutions that allow them to facilitate client business, while improving balance sheet usage. Therefore, the seamless integration of voice and electronic coverage will become increasingly important as clients will always expect to be able to perform any part of the value chain (pre-trade and post-trade) electronically or by voice and, moreover, be able to switch channels on any individual transaction.

To conclude, client consumption behaviour has changed dramatically across all client segments. There is now a much greater emphasis on electronically traded products (cash and derivatives) as clients find them easier to ‘risk-manage’. Many clients prefer this method of executing their trades, as it proves to be cost-effective and provides an excellent level of transparency, facilitating the marking-to-market of positions.

The growing movement towards electronic trading has already been visible in the past two years when electronic trading of credit products has more than doubled – and it is likely that this will continue to increase in the foreseeable future.

Overall, it is apparent that the proliferation of electronic markets, driven by the many factors outlined earlier, will create a more seamless offering across the asset classes in the pre-trade, trade and post-trade spaces.

In response to the changed regulatory environment, Deutsche Bank has continually investigated and invested in new forms of trading OTC derivatives in order to comply with the new regulations. In February 2011 Deutsche Bank, acting as dealer and processing agent, and US-based hedge fund BlueMountain Capital Management executed the first ever credit default swap (CDS) trade that was executed and cleared electronically. This trade clearly demonstrates DB’s legacy as a leader and first-mover in the movement towards e-trading and represented a key milestone in the road to derivative reform.

The key challenge will then be for market participants to adapt to and monetise this new market structure in order to avoid getting left behind.

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