Increased electronification, higher costs, and lower yields for LPs: How will FICC markets evolve?

All market participants desire efficient markets and low cost risk transfer. Electronification has seemingly offered a path to achieving this. However, is the current model unsustainable? Vivek Shankar investigates.

Vivek Shankar

The financial markets have evolved constantly since their inception. The advent of electronic trading ushered in an era of efficient execution and tightening top-of-the-book liquidity. Common wisdom suggests electronification unlocks greater value for investors and drives costs lower.

However, the reality that LPs face is much different. Electronification has introduced costs into workflows that result in LPs realizing zero net marginal returns. A part of this result is created by trading platforms charging fixed fees that allow steady margin collection for themselves.

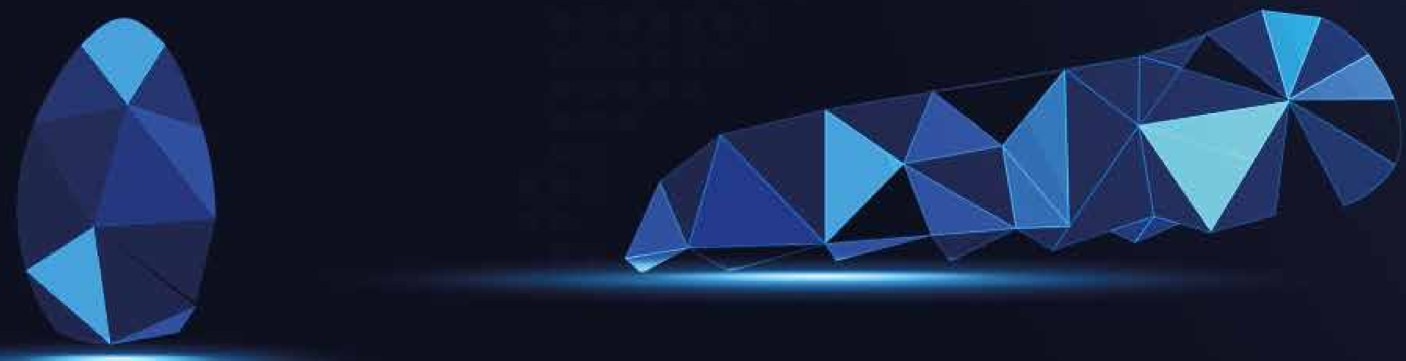
Thus, LPs face a situation where unfavorable trading protocols make it impossible for them to achieve returns on their cost of capital. As the industry grapples with this issue, the following fact has become clear: Trading on multi-dealer platforms under current protocols is unsustainable.

INCREASING COSTS AND IMPACT ON LPS

The global spot forex (FX) market witnesses some of the most sophisticated use of technology in delivering liquidity and managing risk. As such, it's a good proxy for measuring the rate at which technology has played a role in creating the modern market landscape.

FX markets have almost entirely transitioned away from voice-driven order management systems. Data collected in Coalition Greenwich's 2019 Global Treasury Services Facility indicates that 58% of investment management order flow and 61% of corporate order flow is executed via multi-dealer platforms.

Despite the presence of multiple order channels, the data confirms that spreads have shrunk to a point where marginal market-maker yields have plunged to zero. Meanwhile, the costs charged by intermediaries have not



> **"...research indicates that execution costs are not necessarily lowered by increasing the number of LPs accessed."**


Nickolas Congdon

reduced at the same rate and clients suffer because of it.

Nickolas Congdon, head of eTrading services at Commerzbank, is well aware of the issue and its possible consequences. "There's been a paradigm shift in how spot FX is traded" he says. "Technology is the driving force behind this and the divergence is increasing between those that have the resources to innovate and advance and those that do not."

The costs across the board have risen steadily for LPs. Data released by J.P. Morgan suggests that as of Q4 2020, indexed trading volumes were as high as ever while yields firmly remained close to zero.

It's crucial to note that incremental costs that LPs incur are eventually passed onto clients. Zero yield doesn't mean better execution. As Thomas Jacques, Senior Research Manager at Coalition Greenwich explains, "Clients may be disadvantaged as over the medium term, LPs will rationalize their businesses and only focus on the markets where they have a competitive advantage and can capture a return. Hence we may see reduced liquidity in some markets." The zero yield phenomenon is also prevalent in credit markets. Clients are increasingly aware that the rates offered on a platform aren't the same as the ones offered by their LPs, thanks to hedging costs and indirect fees charged by platforms. Brokerage costs are determined via complex fee schedules. Platform participants also face a range of implicit and explicit costs, including credit intermediation, platform, ancillary service, data, and administration costs.

One of the most irksome costs occurs when trading activity data is captured, repackaged, and sold back to end-users. Typically, these data feeds are charged in aggregate, and attributing them to individual transactions is tough.

Trading volume-based costs are also hard to justify. For instance, should a platform charge 10X the fees for executing a $1bn notional versus a $1mm notional ticket? After all, the platform doesn't assume any credit risk or face any additional costs when executing either trade.

Lastly, market participants also face the cost of information leakage, which is hard to quantify. RFQs sent to large third-party platforms pose significant hurdles to achieving market efficiency and place strain on a market participant's ability to hedge their books.

Currently, economies of scale are the only way of dealing with this challenge. This will force consolidations on both the buy and sell-side. Given the high costs of establishing and maintaining a market-making business, market participants expect larger LPs to capture greater portions of order flow. Smaller firms will be forced to focus on their core competencies and priced out of certain lines of business.

DIRECT CONNECTIVITY- A POSSIBLE SOLUTION?

As electronic volumes increase, costs rise, and market participants (except for platforms) face diminishing returns. Jacques identifies one possible solution. "A cap and floor fee model is something we are seeing platforms introducing. It is third-party platforms that are bringing in these models as they seek to partner with their buy and sell-side stakeholders in response to concerns being raised." he states.

There are other solutions afoot as well.

Currently, the buy-side is aware of the issues that LPs face and are working with them to determine the best possible execution methods for their transaction flow. Some platforms are also working with LPs to create a healthy ecosystem that ensures fair outcomes for everyone involved.


Thomas Jacques

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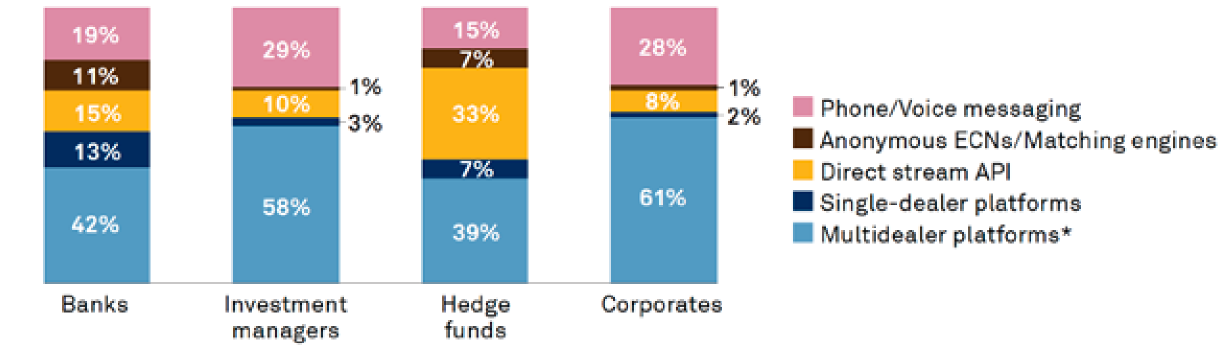
Weighted FX Trading Volumes by Channel



Note: *Full amount RFQ/RFS. Based on 811 top-tier institutional FX users.
Source: Coalition Greenwich 2019 Global Treasury Services Facility

However, the larger question that participants are tackling involves the efficiency of the RFQ-driven trading models. Larger LPs desire interacting directly with clients and feed prices into liquidity takers' order management systems (OMS) via application programming interfaces (APIs).

Subodh Karnik, Head of Client Intelligence Marketing at Coalition Greenwich, believes this makes a lot of sense. "Connecting via an API eliminates brokerage costs incurred while executing on a platform. Moreover, APIs reduce implicit costs as there is less inherent information leakage. Although obviously there are initial investment, and ongoing maintenance costs in running an API" he says.

While direct connectivity eliminates some of the challenges of the current model, it brings hurdles of its own. LPs face a tough time getting buy-side firms to switch since policies mandate traders seek multiple price quotes to ensure competitive outcomes, even if best execution isn't guaranteed.

"There is an element that the buy-side may believe they will receive better pricing if they reach a wider range of LPs through an MDP or ECN network," Commerzbank's Congdon says. "However, research indicates that execution costs are not necessarily lowered by increasing the number of LPs accessed."

Setting up direct connectivity channels brings high initial outlay costs. The result is firms find it simpler to connect to a central platform. There are solutions mitigating this problem in the market currently. For instance, API hubs standardize connections for everyone but maintain distinct information channels. Channel data is never aggregated or sold, and costs are kept to a minimum, ensuring a fair environment for all participants.

OTHER SOLUTIONS

Another possible solution that has emerged is EMSs that aggregate multiple LP execution APIs. Congdon points out that, "...there has been increased growth in venues such as FXSpotStream where clients can access multiple LPs via a single API."

The issue is that such functionality has significant costs, with most participants paying per-transaction or per-notional fees. A cap and floor model as Coalition Greenwich's Jacques suggests might reduce the inequity in such systems.

For now, many buy-side firms have invested heavily into integrating third party platforms into their workflows. Costs of change are a significant consideration for firms adopting this solution. Switching platforms has monetary costs and qualitative costs since traders need time to familiarize themselves with new systems.

There are also constraints on the choice of execution venue. Buy-side firms have worked to retain the right to choose LPs, but market structure and technology limitations prevent them from fully exercising their choice.

Meanwhile, as yields plunge to zero and volumes increase, competition is increasing with new communication channels emerging. Some of these new competitors have delivered EMS/OMS solutions in fixed income. As such, they're playing a significant role in dictating how the markets evolve.

MARKET EVOLUTION

Regulators have focused their attention on these new communication channels to determine whether they meet the definition of a multilateral system. If so, the consequences could be significant. If the new systems have to register as regulated trading venues, costs will increase, and the benefits that participants currently gain will be erased.

While the industry is appealing to

Brokerage Fees—Explicit and Implicit Costs

COST	DESCRIPTION
Execution costs	The individual costs to trade on a platform. These are normally scaled by notional—so a $1bn notional trade costs 1,000x as much as a $1mm notional trade.
Credit intermediation	Per ticket cost for provision of credit intermediation.
Platform costs	The fixed fees charged by platforms in order to trade on the platform. These can take the form of end-user licenses.
Ancillary service costs	Charges from platforms for services such as credit netting, limit monitoring, etc.
Data fees	Charges related to accessing market data necessary to build a price.
STP charges	Costs related to post-trade ticket servicing.
Platform administration costs	Charges related to the production of trade reports, etc.

Source: Coalition Greenwich 2021

regulators and hopes that innovation won't be throttled, there are no guarantees. Buy-side firms, for their part, are evaluating alternative trading rules and methods. For instance, in the credit and rates markets, more firms are exploring rules-based trading instead of the traditional RFQ model.

A part of this move is dictated by the buy side's desire to control more of their data and avoid information leakage. Greater control over data would enable them to selectively send flows to dealers, thereby avoiding revealing their hands.

For their part, dealers have worked to respond to RFQs on a systematic basis. They've reworked their strategies to respond holistically to flow rather than leave it up to individual line traders to respond to requests. Long-only managers and insurance firms have begun adopting portfolio trading in an all-or-nothing context to minimize information leaks. This move is in response to the inefficiency in sending out large orders to a long list of LPs who might not fulfill the manager's instructions.

A NEW DAWN

As electronification continues to change markets, market participants are reacting to conditions. With the drive to zero yields a reality, LPs, buy-side firms, and dealers alike are reconsidering their business models. There are a few promising solutions, such as direct connectivity via APIs, but significant hurdles remain. So what does the future hold?

Subodh Karnik

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"Markets function best with the appropriate level of transparency for the given asset class," says Jacques. "We're already seeing a blurring of the lines between buy and sell sides, and I expect this to continue." In practice, this might mean that the buy-side becomes a source of liquidity while the sell-side provides services that manage risk transformation.

Karnik adds, "This may take the form of provision of interesting solutions or it may take the form of going back to the future and focusing on relationships while other specialized firms with little client business, focus on market-making."

There's no doubt that the markets will evolve into a better version of what we're witnessing today. Ensuring a balance between enhanced transparency and business viability offers the best way to move forward.