

Trends in European Fixed Income Market

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Contents

- 3 Trends in Fixed Income Market
- 3 Business and Market Issues
- 5 Improving Post-Trade Infrastructure
- 6 Rollout of New Solutions in Fixed Income
- 7 Role of MiFID
- 8 About Broadridge

Trends in Fixed Income Market

The fixed income market in Europe today is being affected by a number of developments, many of them relevant for capital markets as a whole. The move towards greater electronic trading has transformed the way equity and also FX trading is done. Increasingly, fixed income trading is also changing for the better. Similarly, the positive impact of MiFID on the European equity markets has led policymakers to consider similar regulatory measures for the fixed income space. While MiFID has already brought greater awareness of best execution practices, MiFID II is expected to strengthen these practices and lower barriers for trading between countries within Europe. Algorithmic trading and transaction cost analysis (TCA) are also beginning to change the fixed income landscape globally, and Europe can no longer avoid these developments. In this paper commissioned by Broadridge, we look at some of the leading trends identified by Celent that will be instrumental in shaping the fixed income landscape in Europe in years to come.

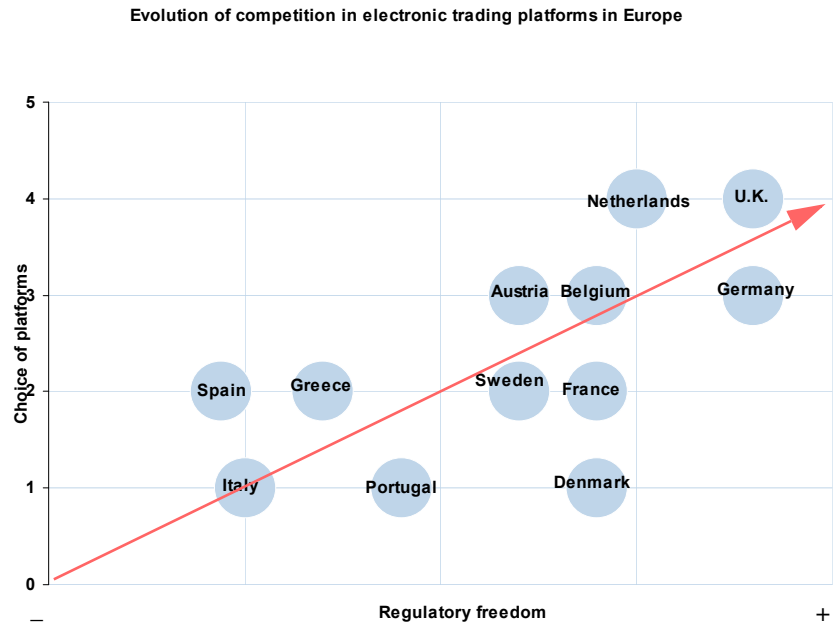
Business and Market Issues

Electronic trading in the European bond market cannot be looked at in isolation from the repo and derivative markets. There has been a rising trend in these markets to move towards electronic trading. Repo markets are highly standardized and lend themselves well to electronic trading, whereas the derivatives markets have come under increasing regulatory pressure to improve transparency and electronic trading. CCP clearing and exchange-based trading are seen as different ways of increasing the same. Since bond trading is closely connected to these markets, it is believed that it would move towards higher levels of electronic trading over time, as the global economy returns to normal and volatility decreases.

The primary dealer system that prevented free competition has been removed in a majority of the main markets. The quoting obligation system for primary dealers (PDs) meant that only business transacted on government-backed trading platforms such as MTS (across Europe), Senaf (Spain), and HDAT (Greece) was considered towards the PD's quoting obligation and participation in the fixed income markets. Hence, there was a strong disincentive to transact on any other platform. France, Belgium, Austria, and the Netherlands have moved away from this and towards more competition by allowing trading platforms

such as ICAP or BGC to compete with the existing MTS platform. But countries such as Italy, Greece, and Spain still lag behind. Italy is the only country to continue with a PD quoting obligation system for repo trading. Hence, different markets have evolved at different levels. This prevents development of a common market and common trading platforms in the way they developed in the US.

Figure 1: Evolution of Competition in Electronic Trading Platforms



Source: Celent

It was believed that a number of multi-trader platforms existing together would fragment liquidity, but this has not been the case.

The main reason is that technology has bypassed the problem through the development of aggregators such as Ion Trading, icubic, and List Group. These pull prices from across different trading platforms and thus can offer the best prices on a single screen to the trader. This is a strong argument in favor of liberalization of the markets.

The crisis has meant that market participants have been reluctant to invest more in electronic trading.

Until there is a rise in revenues, firms will be reluctant to move to newer platforms or better versions. This is expected to change in the mid-term because the primary fixed income markets are performing well, but it has definitely affected the growth of electronic trading in the interim.

Improving Post-Trade Infrastructure

Post-trade transparency and TRACE. The US introduced a trade reporting system for corporate bonds with the introduction of a Trade Reporting And Compliance Engine (TRACE), on 1 July 2002. It covers agency debt from March 2010 and asset-backed securities from 2011. The system reports post-trade information—within 15 minutes—of transactions below \$5 million at par value. The implementation of TRACE in the US has reduced trade execution costs, reduced spreads on more liquid bonds, and improved corporate bond valuation. However, it is not necessarily suited for Europe because the European markets are more competitive. In Europe, it is common for the national banks to compete with dealers to offer bonds to wholesale and retail investors. Also, the frequency of trades is higher in Europe than the US. Finally, the effective post-TRACE spreads in the US are not necessarily lower than European spreads. Another reason that TRACE is not an ideal solution is the feedback from market participants, who believe that, while it certainly led to greater transparency, it did not increase liquidity in the markets. The anonymity often desired for large trades was not available. As per a recent survey by Association For Financial Markets in Europe (AFME), buy side participants believe that a TRACE-like system could result in greater access to executed prices, but could also diminish competition. The sell side echoes this opinion, expecting worse pricing for investors. Trading platforms foresee decreased liquidity and a market where it becomes harder to offload less liquid bonds.

Post-trade infrastructure for fixed income OTC transactions is not efficient, and many transactions cannot be centrally cleared. There is a clear need for the situation to change to allow significant growth of the European fixed income market. We have seen strong adoption of clearing in bilateral repo transactions, which demonstrates the demand for this approach by market participants. As the tendency to reduce counterparty risk strengthens and there is greater standardization of products, we believe that the post-trade infrastructure would receive a fillip through higher use of CCP clearing and the associated gains in efficiency and risk management. Also, the growth of multi-asset trading is driving the need for post-trade infrastructure to evolve accordingly. Trade processing and settlement solutions have become more sophisticated, and market participants have to ensure they have the right capabilities in this scenario.

Rollout of New Solutions in Fixed Income

Algorithmic trading is still nascent in European fixed income.

Algorithmic trading is becoming more common in the US markets, with US Treasuries reported to have as much as 40% of their volumes traded through algorithmic trading in 2010. The main participants include the aggregators, banks, order managers, independent software vendors, and the high frequency traders. From the buy side, the hedge funds have been the main advocates of such trading. An innovation for the credit market that could well lead to more widespread algorithmic adoption is the introduction of limit orders into the historically quote-driven market. Limit orders help clients who intend to buy or sell something when it reaches a certain level; rather than constantly testing the market with requests for quotes, they can leave a straightforward limit order and do not have to continually monitor the market. However, this trend has been slow to affect the market for European government bonds. An important reason was the financial crisis, which triggered a sharp fall in electronic trading. Voice broking became dominant, and electronic interdealer-broker trading platforms such as ICAP BrokerTec, MTS, and BGC eSpeed, along with dealer to client platforms such as Tradeweb and MarketAxess saw, a recovery in volumes only from end-2009 onwards. Another reason is that fragmentation in the European markets is not conducive to electronic trading.

Trade cost analysis picking up in Europe. Like algorithmic trading, trade cost analysis has become more popular in the US than it is in Europe. Demand for transaction cost analysis of fixed income trades is on the rise as dealers deal with higher costs and aggressive new regulatory guidelines. Since fixed income trading outside of government bonds is not as fast as it is in equities, most TCA reporting has been done on a quarterly or monthly basis. The rise in trading costs in the aftermath of the crisis is also boosting demand for fixed income TCA. In Europe, platforms such as Tradeweb are offering TCA for European government bonds. It is expected to become more significant with the implementation of MiFID II, because the rising transparency and informational disclosure is expected to boost the buy side's interest in understanding their performance in terms of best execution and prices.

Impact on the back office. The rise in volume associated with electronic trading, especially algorithmic trading, and greater attention being paid to risk management and transaction costs means that back office processing is becoming more complex. As a result, there is a need for firms to seek internal or third party solutions that will be able to cope with the greater complexity in the next few years in the form of higher volumes and shorter timelines.

Role of MiFID

MiFID has driven the way business is conducted in the fixed income markets. Trading platforms lobbying for freer competition have found that the MiFID regulation has also been instrumental in changing the mind-set of the respective bureaucracies. It is now easier to convince governments of the need for free competition in light of the general success of MiFID in the equity markets. MiFID gave member states the option to broaden the transparency regime to financial instruments other than shares. However, only Italy and Sweden exercised this option and extended this regime to bond markets. An important reason for this is that non-equity markets have a different microstructure than equity markets, and trading mechanisms are designed to enhance resilience in case of liquidity issues. A general choice to opt in may not provide enough incentive for member states to exercise the option. If they deviate from their current application of MiFID, they may put their own markets at a disadvantage, particularly if they impose stricter requirements for non-equity instruments. In spite of these reservations, MiFID has led to the broad application of the best execution requirements in the European markets. This is best exemplified by the rising use of the request for quotes mechanism by participants that trade electronically, because this allows them to satisfy best execution.

Expected changes under MiFID II. In its recent review published in December 2010, the European Commission has proposed that investment firms willing to quote or receive an RFQ (probably run on organised trading facilities) would be asked to make price and volume available to the public and eventually commit to it for sizes below a certain threshold (retail size). The threshold will be specified per asset class. It is believed that there is a greater need for pre-trade transparency in the retail markets, where it will reduce search costs. However, in institutional markets, pre-trade transparency may not be of any help if it does not serve price discovery. Some market participants believe that currently available pre-trade data is sufficient, and legal requirements are not needed, since bond markets do not necessarily function as equity markets and because current transparency levels have not limited participation in these markets. Hence, the introduction of any pre-trade transparency regime must prioritise the avoidance of adverse liquidity consequences for involved counterparties and systemic risk.

About Broadridge

Broadridge is a technology services company focused on global capital markets. Through its Gloss solution, Broadridge offers an industry-leading multi-asset transaction processing, settlement and book keeping solution for international operations, enabling firms to capture, process and settle multi-asset instruments in virtually any currency and market.

For more information about Broadridge, please visit www.broadridge.com.

To learn more about the Gloss solution, contact:

Paul Clark on +44 (0)207 551 3000 or email paul.clark@broadridge.com