Swaps e-trading - Adapt or die

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Author: ***ronan.oneill@totalderivatives.com***,
Tel: +44 (0)20 7107 2077

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Experts in the field - from the sellside, buyside and platforms - will address the current issues in swaps e-trading at the Total Derivatives Forum on September 18th. To see an agenda for the day, click here: **Total Derivatives Forum - Agenda**. If you are interested in attending the Forum, please call **Chris Scudder** at Total Derivatives on **+44 20 779 8537** or email **info@totalderivatives.com**.

Swaps e-trading - The sixth stage of change

In the swap market, trade confirmation and settlement are now almost fully automated. Dealers book, document, confirm, clear and settle trades electronically. But the key battleground remains the core *execution* aspect of the e-trading environment – and that is where the rapid evolution is taking place.

The swap market's reaction to the challenge of automation has been interesting to observe. A psychologist might characterize the response as a typical 'seven stage process of change' – 1) shock, 2) denial, 3) frustration, 4) acceptance, 5) experimentation, 6) decision-making, 7) integration.

1. **Shock**: This is what the swap market felt when it realized that Barclays Capital had taken the leap and launched its BARX execution platform on Bloomberg in July 2003.

2. **Denial**: This was the response of BarCap's rivals, who enthusiastically bad-mouthed the launch. "It's bound to fail", "It'll never work", "They're shooting themselves in the foot".

3. **Frustration**: This is what swap traders experienced when it became clear that BARX was a significant success. See: **Automated Trading - The Future for Swaps**, October 2003.

4. **Acceptance**: The other dealers saw the writing on the wall, and rapidly followed BarCap's lead. But the first-mover advantage held, BarCap became synonymous with e-trading and this was crucial in establishing the bank as a top-tier player in the Rates business.

5. **Experimentation** (Exploring the possibilities of the new reality): Since July 2003, e-trading of swaps has moved from unwanted novelty to grudging acceptance. Banks compete aggressively on technology and pricing; the main trading platforms jostle for position.

6. **Decision-making**: (Choices are made between the options presented by the new reality). This is the point at which the swap market has arrived. Although swaps have now been

trading electronically for four years, e-trading volumes remain much lower than might be expected. According to SIFMA, e-trading accounted for only 12% of IRS volume in 2006, compared to 35% in European government bonds. However swaps e-trading volumes grew at a rapid 45% pace in 2006, compared with only 12% growth in e-trading of European governments. Still, e-trading is clearly embedded and sources point out that single-dealer swap platforms on Bloomberg remained active through the recent liquidity crisis – one of the most testing times for the swap market over the last decade.

7. **Integration**: Full automation. This is where the swap market will be in 5 years' time. But the question is: Which players will come out on top?

To summarize, the swaps market has accepted automated execution (e-trading) and has been exploring how best to incorporate e-trading into the broader Rates business. It is now at the crucial "decision-making" point in the seven stages of change. This is a watershed moment: the decisions made now – both by the big derivatives dealers and the trading platforms – will determine which players thrive in the next, and final, 'integration' phase. It's all to play for.

So why is the e-trading of swaps so crucial to the Rates business?

The importance of Rates e-trading - $50bn of annual revenue

According to research from the Boston Consulting Group (published before the credit/liquidity crisis) the global Fixed Income Currencies and Commodities (FICC) business will generate revenues of $162bn for investment banks in 2007, up 13% from the record revenues of $143bn delivered in 2006. FICC now accounts for just over half of all investment banking revenues.

Within FICC – and investment banks as a whole – the 'Rates' department is the single biggest business line. BCG forecasts that in 2007, global Rates revenues will reach $52bn, well ahead of Credit ($41bn), Cash Equities ($40bn) and FX ($32bn). Rates is a big business. It's no surprise, then, that the banks are jealously protective of this revenue stream.

The automation of the swap market – the core of the Rates business – has the potential to fundamentally shift the competitive landscape. As Barclays Capital has demonstrated over the last 5 years, a first-mover advantage and focus on e-trading can help catapult a derivatives dealer up the rankings and into the top tier. As volumes in the swap market continue to rise and the market becomes increasingly commoditized, the level of e-trading expertise will determine the winners – and losers – in the Rates business in the decade ahead.

The experience of the FX market – which is perhaps 10 years ahead on the e-trading curve – provides a sobering reminder of what can happen to a revenue stream, once a market goes automated.

How to kill a revenue stream - A history of e-trading in FX

In 1993 a consortium of 12 banks invested $50m to set up the EBS FX platform, to complete against Reuters Matching, which was then the pre-eminent FX trading system. By 1995, EBS volumes had exceeded those at Reuters Matching, so the aim had been achieved – but at a huge cost.

The consortium sold EBS to ICAP for $825m in 2006, so the dealer-shareholders did quite well on the investment. But that profit was only a fraction of the losses incurred in lost spot FX revenues as a result of the intense competition between EBS and Reuters Matching, which increased transparency and crushed bid-offer spreads.

Crucially, the major spot FX dealers lost control of the customer relationship. And within the market there were big winners and big losers. Those banks that invested heavily in e-trading systems won the battle for market share. The concentration of volumes is now so extreme that, according to the Euromoney FX poll 2007, the top 5 FX dealers (Deutsche, UBS, Citigroup, RBS, Barclays Capital) together control 60% of the market share in FX.

In the Rates business, market share is much more widely distributed, with around 15 major swap dealers. But there is great potential for e-trading to transform the Rates landscape, as it has already done in FX, and result in a much higher concentration of market share.

With the lessons learned from the FX experience, the big swap dealers are determined to prevent the same thing happening in Rates. The banks have accepted that bid-offer spreads in the core swaps business are bound to compress further as automation increases and volumes rise. But they are determined to maintain close relationships with clients, to establish their ownership of the intellectual property implicit in price information, and thereby retain control of the market itself.

And with rivalry intense, the top-tier swap dealers are anxious to ensure that they are in the top 5 (and preferably top 3) market-makers of the future. Meanwhile those dealers below the top tier are at pains to ensure they remain in the business.

The platforms - Driving the pace of change

Alongside the swap market-makers, the key players in the e-trading landscape are the trading platforms – indeed it is this group which has helped drive the pace of change. The rivalry between the platforms is just as intense as that between the dealers – they are at the centre of the battle for control of the swaps market, and the Rates business.

The trading platforms have been very successful in other products, but swaps has so far been very slow to take off. Single-dealer swap platforms are doing reasonably well, but the multi-dealer swap platforms have not been a success. In contrast to Treasuries, for example, volume data for e-traded swaps is hard to come by – because there simply isn't much going through and the platforms would rather not emphasize that uncomfortable fact.

The lack of volume in e-traded swaps reflects resistance from the banks, which are determined to maintain control of this core market and are concerned that that may cede some control, and value, to the platforms. This fear has led to the latest developments in e-trading of swaps, which we discuss below.

But first, at the end of the 5th 'Experimentation' phase, we review the existing infrastructure:

- **Bloomberg**. The US data provider, run by the combative Lex Fenwick, is the big hitter in the platform business. While Bloomberg was a little slow to grasp the potential of e-trading in the 1990s, it didn't take long to catch up. The ubiquity of the Bloomberg terminals in the fixed income markets means that there is a ready-made platform. And Fenwick saw the provision of e-trading functionality as a way of embedding the Bloomberg terminal in trading floors worldwide, both among the big sellside dealers and their clients. In 2003, Bloomberg hosted BARX – the first swap execution platform – and is the leading provider of single-dealer swap-trading platforms. In 2005 Bloomberg launched SwapTrader – its multi-dealer platform.

  But last year it attempted to take a step too far. Finding that going it alone with SwapTrader wasn't delivering the hoped-for volumes, Bloomberg planned to re-launch the platform as a new entity – SwapsHouse – in which both Bloomberg and the big derivatives dealers would be equal equity partners. But most banks balked in the face of what were described as Bloomberg's "aggressive tactics". The banks feared that media giant was attempting to dominate the swaps e-trading arena, and in particular take control of the intellectual property – trading information – which the banks considered to be theirs. The consequent collapse of the SwapsHouse product ultimately led to the formation of LiquidtyHub, of which more below.

- **Reuters**. Historically, Bloomberg's key competitor, Reuters has always been a distant second in fixed income, and its competitive position has only worsened in recent years. Despite its leading position in the e-trading of FX, Reuters was unfathomably slow to transfer its expertise in FX to the fixed income asset class. It has now developed 'Reuters Trader for Fixed Income' (RTFI), but this platform has to date made little, if any, impact on the swap market.

- **TradeWeb**. Owned by Thomson Corp – the third of the big information providers – TradeWeb is Bloomberg's arch-rival in swaps e-trading. Lee Olesky set up the dealer-to-customer trading platform with Jim Toffey while at CSFB in the US in the late 1990s. Originally owned by a consortium of dealers, it was sold in May 2004 to Thomson, which beat Reuters in a bidding war to buy the platform for $385m in cash plus contingent payments of up to $150m based on growth targets over the following 3 years.

  Why did the dealers sell their own platform? Thomson Financial CEO Sharon Rowlands said, "at Thomson we appreciate that the dealers involved in TradeWeb entrusted this key asset to us… it certainly seemed to me that their motivations were as much about who could partner with the industry and add value as it was about price…" What did she mean? Possibly that the fixed income industry felt that Bloomberg was simply becoming too powerful in the e-trading arena and that a strong competitor was required. Thomson TradeWeb fulfilled that aim.

Shifts in the landscape - LiquidityHub, Project Fusion and the CME Swap

Now, as 2008 approaches, the 5th 'Experimentation' phase is ending; the 6th 'Decision-making' phase has arrived. And at this key interface, major shifts are occurring in the e-trading landscape.

- **LiquidityHub**. The first key development is the imminent launch of LiquidityHub, originally known as 'Project Hermit', when it was conceived as an alternative to Bloomberg's SwapsHouse in early 2006 (see: **E-trading of swaps -- Battle lines drawn**).

  In May of this year, LiquidityHub announced that it had agreed distribution agreements with Reuters and Bloomberg (see: **LiquidityHub announces Reuters, Bloomberg links**). TradeWeb was noticeably absent from the deal.

  The launch of the initial product group – USD and EUR interest rate swaps and US Treasuries – was originally expected in midsummer but has now been pushed back to early October, according to e-commerce sources. A 'pre-launch' version will be available by the end of this month for testing with a select group of clients. European government bond trading is expected in early 2008.

  CEO Robert MacLeod, a former director of fixed-income technology at Morgan Stanley, describes LiquidityHub's mission as "to aggregate liquidity and market data and to promote efficiencies in the marketplace." MacLeod also has the unenviable task of answering to the 15 competing dealers which form the consortium.

  LiquidityHub will introduce a new trading protocol, Request for Stream (RFS) which, according to the consortium, will allow the buy-side to "view a stream of executable prices from a selected group of known dealers once a trade session has been initiated". A composite screen will enable a discrete trading session that a client will initiate with a number of swap dealers. The service will be non-exclusive, so end-users will be able to access the same banks on single-dealer platforms on Bloomberg, for example.

  LiquidityHub has a lot of support in the market – that is, among the major derivatives dealers. It is a non-profit-making organization and, like SwapsWire, can be seen as a utility for the market, which acts in the best interests of all participants. In this respect it distinguishes itself from TradeWeb, for example, whose primary purpose is (of course) to make profits for its shareholders. The swap market as a whole is keen to avoid the perception that it is operating a cartel, which may come in for unwanted attention from regulators. The fact that LiquidityHub is a non-profit entity may help to assuage any potential antitrust concerns.

  But LiquidityHub does have its detractors among the buyside who claim that its purpose is primarily protectionist – to help preserve margins for the dealers, and to maintain their tight control over flows and information. Some of the active buyside e-traders have suites of single-dealer platforms arrayed on their Bloomberg screens, linked to spreadsheets which select the best prices at any given time. Some suggest that an array of 'click-and-trade' single dealer platforms would provide than LiquidtyHub's 'Request for Stream', and ask whether their interests are served by the new RFS protocol. They suggest that on the contrary, the imposition of RFS as a standard is an attempt to control the market.

  Nonetheless, LiquidityHub sees itself as the natural next step in the e-trading of swaps, and many dealers agree. But not everyone sees it that way.

- **'Project Fusion'**. In a recent interview with Euromoney Magazine, MacLeod said that, "in a perfect world TradeWeb would be a partner as well."

  But so far the Thomson-owned platform has rebuffed LiquidityHub's advances. Indeed, TradeWeb is an integral part of plans to develop a new, evolved, platform also supported by a consortium of dealers and which would provide a powerful rival to LiquidityHub. And, as seems popular in e-trading circles, this enterprise has been allocated a codeword – 'Project Fusion'.

  The mere existence of Project Fusion is company confidential information, and no-one will discuss it openly. The active participants have all had to sign NDAs (non-disclosure agreements). Chinese Walls have been raised both inside Thomson and Reuters *and* within the derivatives dealers active in the Project. *Total Derivatives* has discussed Project Fusion, off-the-record, with a number of contacts in the e-commerce and swap trading fields. While there is a wide range of opinion on the wisdom of this project, all agree that the situation is "very fluid". As such, the detail below is subject to revision as events unfold.

  The TradeWeb buyout period is now coming to a close. Thomson attempted to integrate TradeWeb into its Thomson Financial unit but was never able to fully leverage the platform's potential, particularly in the swap market, which resisted TradeWeb's overtures. Still, TradeWeb has in general performed very well in the 3 years since its acquisition. We don't know for sure how much Thomson paid out, but we make the assumption that contingent payments reached the maximum $150m, meaning that Thomson paid $540m in total.

But now, our sources tell us, Thomson is attempting to sell a 30% share of the business (and perhaps control) back to a total of around 10 dealers for $40m each. That would value the company at around $1.33bn. Apparently 9 dealers are currently in active discussion with Thomson. That is, the dealers are considering buying back the platform that they sold 3 years ago, but at around 2.5 times the original sale price. Goldman Sachs is said to be a key player in the attempts to get Project Fusion off the ground.

Of course Project Fusion raises a number of fundamental questions. For example, if LiquidtyHub is already the dealers' platform of choice, why do some dealers feel it needs a competitor? How can LiquidityHub distribute over Reuters terminals if the new Thomson-Reuters is the majority shareholder in a competing platform? If LiquidtyHub distributes solely over Bloomberg, can it really lay claim to be the 'default' liquidity pool?

These issues are yet to be resolved, but it is clear that if Project Fusion comes to fruition then it is going to blow a hole in the vision for the market's future that gave rise to the LiquidityHub concept. There is an irony here: LiquidityHub was the ultimate result of the swap market's sabotage of Bloomberg's SwapsHouse initiative. Now LiquidityHub itself may become the victim of similar hard-ball tactics.

- **CME Swaps on Swapstream**

But in these liquidity and credit-sensitive times, the most interesting development of all, perhaps, has been the entrance of CME Group into the swaps e-trading arena.

The Chicago leviathan has previously remained on the sidelines, but it now plans to add swaps to its broad portfolio of exchange-traded instruments. Last year's strategic purchase of Swapstream, run by swap market veteran Stephane Rio, brought a much-admired OTC e-trading technology to the CME Group, and it now plans to leverage that technology to create CME Swaps on Swapstream.

In a departure from the previous strategy employed by various exchanges, the new product – CME Swaps on Swapstream – is not a futures contract. It is simply a forward-starting IMM swap that is centrally cleared by CME's well-established Central Counterparty Clearing (CCP) system. The idea is to provide the flexibility and risk characteristics of an OTC swap and combine that with the transparency, operational and capital efficiencies of exchange-traded futures.

On an operational level, the CME Swap boasts streamlined processing: automatic position netting will eliminate the need for cumbersome unwinds and assignments. No ISDA documentation is required, and swap confirmations will become unnecessary.

Swapstream will offer USD and EUR-denominated swaps out to 30-years as well as OIS out to 12 months. The platform will facilitate calendar and butterfly spreads and offer a futures cross as well as outright and block trading (privately negotiated trades outside the platform). Importantly, and unlike all the other e-trading platforms, trading of CME Swaps on the Swapstream platform will be anonymous – there will be no name give-up as in all OTC swaps. However Swapstream will also offer RFS functionality, like LiquidityHub, for all "off-the-run" and complex products. The platform will allocate a specific number of market makers who will stream prices on the benchmark products and reply to the RFS.

But this new product may be of most interest to risk and credit departments. The CME Swap will minimize counterparty credit risk via the CCP system and margining based on a daily mark to market. Cross margining will be available with other CME products, most usefully Eurodollar and T-Note futures, and positions are automatically netted. Bilateral collateral arrangements will be replaced by consolidated collateral management. Clearly these multiple features will all serve to free up counterparty credit lines and reduce capital requirements.

The transparency, anonymity and ease of use of exchange-traded swaps will all be popular attributes for swap end users. The key challenge for CME and Swapstream, however, is to secure the support of swaps market-makers, who are concerned about bid-offer compression and a loss of flow information. But Swapstream hopes that its move to allow block trading and the increasingly popular RFS protocol will secure buy-in from the market-makers who will be able to serve their clients as they do now, while taking advantage of the efficiency of a centrally cleared product.

Consequently, it is the potential for CME Swaps to significantly reduce the credit and liquidity risk inherent in the OTC swap market – a factor which is of clear benefit to the banks as well – that may turn out to be its winning feature.

Conclusion – Adapt or die

Investment in e-trading of the core swaps product is a critical element in reinforcing, or establishing, dominance in the Rates business. By embracing new technology and building a comprehensive e-trading capability in the core swaps product, banks will be able to leverage their investments in higher-margin rates product.

Leading derivatives dealers are pumping investment into e-trading of swaps in an attempt to replicate the success and market share of the top five banks in FX.

The precise nature of the swaps e-trading arena is yet to be decided. LiquidtyHub is – on the surface at least – an attempt at reaching a consensus which would be beneficial for all market participants. But the inter-dealer and inter-platform rivalries which have given rise to Project Fusion are potentially fatal to LiquidityHub's aims. Meanwhile the CME and Swapstream are preparing to bring the transparency, operational and capital efficiencies of central counterparty clearing to this quintessentially OTC market.

The swap market is in the sixth and critical "decision-making" stage of change – a period of rapid flux, but one from which clear winners – and losers – will emerge.

However things turns out, though, it is clear that e-trading of swaps is here to stay and that the proportion of swaps traded electronically will rise rapidly over the next 5 years to exceed 50% of volumes. And through this period there will be an increasing differentiation between commoditized risk-transfer flows – which will shift to e-trading platforms – and higher margin customized transactions, which will be remain within the voice environment.

For all swap market participants, the message, loud and clear, is: adapt or die.