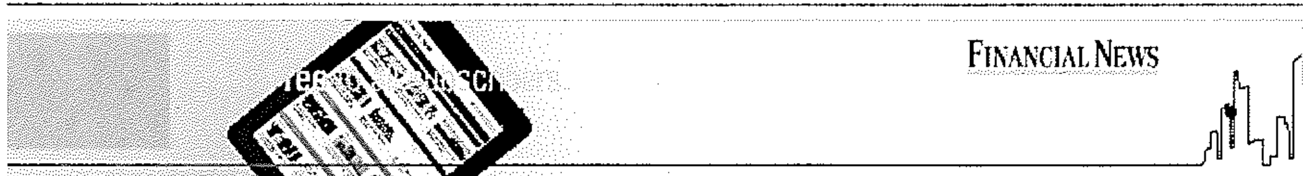

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Dark pool call to transform corporate bond trading

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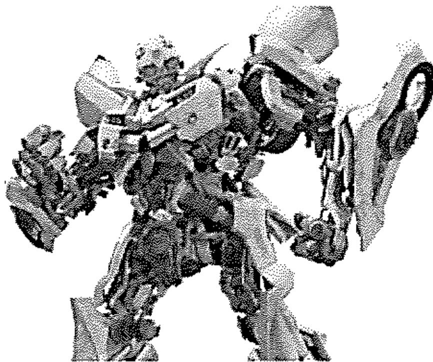
European buyside traders have called for a fresh approach to corporate bond trading to ease the problems of liquidity the market is expected to face when new regulations come in for fixed income next year.



In particular, new rules from Basel will fundamentally alter the way bonds are traded by demanding that banks hold capital on their balance sheets that reflects the risk of their bonds.

Market participants say this has resulted in banks running down their bond inventories. In the US, corporate-bond inventory held by banks had fallen from $218 million at the end of 2007 to $57.5 million at the end of 2012, according to data from the Federal Reserve Bank of New York.

A lack of post-trade transparency makes it difficult to state the impact in Europe, but traders have indicated a similar slump is occurring. Corporate bonds have been hardest hit and sovereign bonds could well be affected once central banks' buying intervention fades.

Nick Robinson, head of trading, fixed income at Schroders, said: "Basel III, the Volcker Rule, the Capital Requirements Directive [IV] and Mifid II will all increase the cost to banks of holding corporate bonds on their balance sheets, which has led to a decline in banks' inventory of corporate bonds. We believe this is a permanent change which has reduced secondary market liquidity and increased volatility."

Franck Chatillon, chief executive of Geneva-based Greenwich Dealing, a provider of outsourced dealing solutions for the buyside, said the challenge will be particularly acute for smaller buyside firms: "The corporate bond market is currently not very liquid and the effects are worse for small and mid-sized asset managers. Investment banks tend to concentrate the liquidity they offer to their largest clients, which is the case in both the primary and secondary markets."

Currently, most institutional trading in corporate bonds is conducted over the counter. Buyside traders

phone banks and brokers to request buy and sell prices for the instruments they want to trade, before selecting their preferred execution partner.

This model requires sellside firms to hold an inventory of bonds on their books, which they use to act as an immediate buyer or seller for client orders. But the slew of post-crisis regulation, which aims to boost transparency and ensure banks are adequately capitalised, is challenging this traditional trading model.

Lee Sanders, head of foreign exchange and money market execution for Axa Investment Managers' trading and securities financing division, said: "Banks' balance sheets are heavily constrained and they don't want to commit as much capital to the corporate bond market as they did previously. There is a need for a new type of platform that combines liquidity from the buyside and sellside to offer more flexibility when it comes to trading corporate bonds."

Some banks, including Citigroup and Goldman Sachs, have tried to go it alone by launching internal liquidity pools that match client orders electronically and include some proprietary flow. Goldman Sachs' GSessions, which launched in June last year, runs infrequent auctions after building interest in high-grade and investment-grade corporate bonds, while Citi launched a platform for emerging market bonds this year.

But some warn that splitting liquidity in this way does not solve the problem. Nathalie Masset, director of European debt markets at NYSE Euronext, which operates the NYSE BondMatch trading venue, said: "Buyside traders have indicated they want a range of different but complementary execution options for trading bonds, as opposed to liquidity that is split across different dealers.

"A multilateral platform makes for a larger pool of liquidity: the more open a market is, the more liquidity it offers, the more attractive its prices and – for buyside firms – the more order execution opportunities there are," she said.

The potential for future difficulties in sourcing bond liquidity from banks was raised at the last meeting of the Alpha Trader Forum, a private buyside roundtable that includes senior traders at asset management firms.

Anita Karppi, managing director at K&K Global Consulting, which hosts the ATF, said buyside traders at the last forum – including Sanders, Robinson and Chatillon – discussed how an anonymous trading platform, or dark pool, could improve access to liquidity.

She said: "For a dark pool to succeed in fixed income, the buyside will need to make a concerted effort to pool liquidity into a small number of carefully selected venues. Any platform provider committed to serve the buyside needs to consider the increasing requirement to provide evidence of best execution and an analysis of transaction costs."

Unlike dark pools for equities, which continue to grow and are currently in the regulatory spotlight across the globe, buyside participants at the ATF said the ideal trading venue for corporate bonds should be accessible by both the buyside and sellside.

This model would allow both types of participant to find matches for their orders without revealing their intentions to the market, which is particularly important for an institutional bond market that is characterised by large trades needing to be shielded from the glare of other market players.

Axa's Sanders said this type of structure would also benefit banks, which can sometimes be left holding small, illiquid positions in corporate bonds from facilitating client trades. Under the new regulations, these illiquid positions would incur a high capital charge.

He said: "A centralised liquidity pool that gives brokers access to a wider range of counterparties could help to free up their balance sheets and preserve a key execution channel for the buyside."

But not everyone is convinced that a dark pool will provide all the answers. Robinson said: "There are approximately 10 times as many bond issues compared with equity issues in Europe. Many of these bonds are tightly held and trade very infrequently so the chances of finding a match in an individual

bond will be smaller than an equity."

He warned that during volatile periods, bond markets can be "one-way", further decreasing the chances of a match. He said: "If everyone is a seller and there are no buyers, then no trades will take place in the dark pool. We believe there is a greater chance of this scenario happening on occasions in a corporate bond dark pool than in an equity dark pool."

• Striking the right balance

In Europe, the corporate bond market will be shaped by two main pieces of legislation that will lead to a radical shift in fixed-income trading: Basel III and the second version of the Markets in Financial Instruments Directive.

Basel III, which will be implemented in Europe through the Capital Requirements Directive IV at the start of next year, will require banks to hold more capital against the bonds on their balance sheet based on their level of risk.

The added cost that will be imposed by Basel III has already contributed to banks cutting the inventory of bonds they hold on their books (see chart).

Mifid II, which is at the final stages of negotiations among European policymakers, will attempt to inject pre- and post-trade transparency into the opaque European fixed-income market.

Mifid II could require banks to make public the buy and sell prices they offer to clients and could introduce a reporting system similar to the mechanism used in the US for corporate bonds, called Trace.

Most agree on the need for more transparency in the European bond market but caution that proposals must be calibrated appropriately.

Christian Krohn, a managing director at the Association for Financial Markets in Europe, said: "A certain level of transparency is needed in the European bond market, but it is about determining what the most optimal approach is.

"Some of the current discussions on Mifid II could impose too much transparency, which will put banks at risk by exposing the positions they have taken on for clients. This could result in a draining of liquidity from the bond market, which will increase transaction costs for investors and therefore the borrowing costs of issuers, whether they are governments or companies."

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