MENDING MARKET MAKING

HOW TO REVERSE THE CORPORATE BOND DEALER SLUMP

The end of 2017 brought another year of underwhelming revenue for fixed income market-makers. While down years are common for Wall St banks, this slump in fixed income is unusually lengthy. Recently, the NY Times published an article estimating that 2016 fixed income revenues for the top 12 dealers were down $27 billion from their peak, while historical data indicates that revenues for both large and small dealers have been in decline since 2009. In the landscape of fixed income products, sectors, and sub-sectors, identifying the specific problem areas for market-makers is a science project unto itself. However, most observers (and participants) agree that corporate bonds are the main suspect in the investigation into falling dealer revenues.

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What fundamental changes are hurting market makers

What techniques will reverse the market making slump

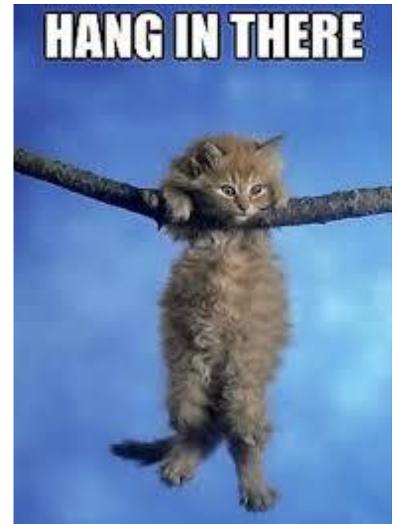
Author: Chris White

CEO ViableMkts

chris@viablemkts.com

End of an Era?

In the first few years after the Credit Crisis, bonus-dependent employees on corporate bond desks and their managers faced an existential question: "Is this just a cycle (down year) or has something fundamentally changed?" Given how good the good ol'days were for individual compensation, it is no surprise that many traders and salespeople faithfully clung to the idea that each down year was just a blip, and that the following year would reverse the negative trend. The decline in overall performance has led dealers to incrementally reduce headcount, which has left many desk veterans looking for new opportunities. As we enter 2018, dealers appear to have finally accepted that corporate bond markets have been permanently altered. Just like any problem, acknowledgement is the first step towards resolving it.



Unfortunately, over the past few years there have been numerous false assumptions about what methods would help dealers achieve success in the new market. Institutions that plan to revive their bond market-making business lines must identify which fundamental changes have rendered some traditional business practices obsolete and prioritize solutions that will positively impact the profitability of corporate bond market-making.

Fundamental Change #1 – Reduced Balance Sheet Capacity

Dealers have been committing less capital to corporate bond market-making over the past nine years. The conventional narrative is that the shedding of balance sheet has been a direct, involuntary response to the Volcker rule. This is not necessarily true for all market-makers. As a means of reducing long-term risk, many dealers imposed capital restrictions and stricter aging policies well in advance of Volcker implementation. This voluntary de-leveraging indicates that even if Volcker is repealed, the low balance sheet, higher-frequency approach to market-making will most likely remain.

False Assumption: Dealers can maintain business performance by focusing more on agency trading instead of principal trading

Agency trading and riskless principal trading have been promoted as new opportunities for dealers that are moving away from principal trading. The reality is that market-makers have always been motivated to match customer orders, but there are limited opportunities to do so because of product fragmentation, timing, and customer concentration.

Suggested Approach: Optimize Principal Trading

Optimizing principal trading, requires market-makers to break from the traditional approach of evaluating buy-side clients based on overall activity and prioritize customers based on the quality of their business. Therefore, dealers must consistently examine the order-flow of individual clients to understand the real impact of their trading activity. If done correctly, market-makers can improve profitability by committing balance sheet to customers who demonstrate long-term commercial value while avoiding buy-side institutions that have unprofitable flow.

Fundamental Change #2 – All to All Electronic Trading

Electronic trading solutions for the odd-lot corporate bond market provide numerous benefits for both buy-side and sell-side institutions and are deeply integrated into daily workflow. Market-makers have now fully embraced electronic trading as a permanent and critical part of their overall business model when managing non-institutional flow.

False Assumption: Performing for US clients electronically (RFQ) will lead to more substantial trading opportunities

Historically, US dealers have attempted to use electronic trading performance in RFQs to differentiate and promote their services as a corporate bond intermediary. However, advances in All to All RFQ trading have significantly reduced the effectiveness of this traditional approach. All to All trading often anonymizes counterparties, so as the protocol gains traction, market-makers are unable to increase franchise recognition through electronic trading performance.

Suggested Approach: Leverage Electronic Order Flow to Reduce Risk

Leveraging electronic RFQs requires market-makers to prioritize order-flow based on desk-fit. RFQs that have the potential to reduce risk, fill another client's order, or substitute for interest in a different bond are the most valuable. Correctly configuring your electronic trading technology to highlight these opportunities can improve dealer profitability by minimizing balance sheet commitments to random, odd lot positions, thereby increasing balance sheet efficiency, which will ultimately enhance the dealers' capacity to perform higher-margin block trades.

Fundamental Change #3 – Voice Trading Workflow

With much of the focus on how electronic trading is changing corporate bond markets, it is easy to overlook the fundamental change that has occurred in voice trading. Over the past 15 years, there has been a profound shift in the way market-makers communicate quotes and inventory to buy-side institutions. Currently, buy-side firms are inundated with Bloomberg messages, chats, XLS spreadsheets, and emails that contain pricing information from dealers. The most advanced buy-side shops are taking action to implement technology to enhance their ability to derive the actual value of a bond by aggregating and normalizing dealer communication. This quest to improve pre-trade information is one of the most critical initiatives in the corporate bond market and has shifted the power dynamics of voice-trading.

False Assumption: To be competitive in the voice market, dealers need to increase the consistency and frequency of their pricing updates

Buy-side technology solutions that organize dealer pricing create a significant information advantage for the buy-side over dealers. This imbalance is caused by the cultural tradition that market-makers display institutional prices to buy-side clients, but not to each other. The result is a market environment where the liquidity takers (buy-side) consistently have more contextual pricing data than the liquidity providers (dealers). For dealers, increasing the consistency and frequency of their pricing updates exacerbates this handicap.

Suggested Approach: Equalizing access to pre-trade institutional pricing information

Instead of focusing exclusively on distributing pricing information, corporate bond market-makers must address a fundamental issue that has developed in the institutional market. **By collectively sending pricing data to customers, but not to each other, dealers in the corporate bond market have put themselves at a significant disadvantage with regards to access to pre-trade information**. While buy-side clients are able to see all available bids and offers in a particular bond, market-makers are limited to their own perspective when determining a bond's value. Embracing solutions that would close the pre-trade information asymmetry gap between would allow market makers to increase profitability by limiting negative selection and improving risk management. In addition, better pre-trade transparency would allow market-makers to service flow in less frequently traded bonds, which would directly translate into increased volumes and revenues.

Improving dealer performance reveals a common theme:

- Assessing the commercial value of an individual buy-side customer requires access to **high-quality pricing data**
- Leveraging electronic order flow to reduce risk requires access to **high-quality pricing data**
- Improving institutional market-making accuracy requires (equal) access to **high-quality pricing data**

Developments that have fundamentally shifted the corporate bond market have led to a non-traditional conclusion: **To increase market-making revenues, dealers must embrace transparency.** This statement contrasts with the traditional notion that a lack of available market data benefits dealers. While this anti-transparency view may be helpful to dealers in the early stages of a market's development, maintaining a model that relies on opacity leaves dealers unprepared as the market evolves and embraces new technology. As other markets have demonstrated, once dealers fully leverage pre-trade price transparency, they dramatically improve overall performance through higher trading volumes and better risk management.