

# Fixed Income moves to centre-stage in electronic trading



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These are exciting times for the development of electronic trading in fixed income markets. A period of relative stability, steady growth and consolidation in electronic trading, followed by the restrictions of the credit crisis has now given way to new developments and the prospect of ongoing change. In contrast to the cash equities market, there has always been more than one fixed income market –several markets, the distinctions depending on the reviewer’s perspective. From the point of view of understanding market trends and potential, we will distinguish between the relatively liquid fixed income markets (government bonds and a limited number of agency and corporate bonds) and the less liquid to downright illiquid bonds comprising the majority of issues (corporate, agency, asset-backed bonds).

In the relatively liquid bond markets electronic trading is long established and in some respects comparable to equities markets. Order matching electronic trading platforms are available to sell-side participants through the Inter-Dealer Brokers and increasingly to buy-side firms through dealer to buy-side platforms, in addition to Request for Quote (RFQ) facilities. Algorithmic trading, previously the preserve of equity and fixed income markets, is now securing a foothold in the government bond markets and facilitating the inclusion of government bonds in multi-asset trading strategies.

The less liquid fixed income markets

present a different set of challenges and opportunities. Electronic trading developments over several years have brought improved market efficiency, largely through the automation of RFQ services, enabling buy-side firms to readily access, compare and action dealer quotes for less liquid bonds. Since the credit crisis of 2008-9 we have seen unprecedented growth in fixed income issuance and investor demand for fixed income. At the same time, a number of sell-side firms have withdrawn from fixed-income market-making while other dealers have limited the amount of capital committed to fixed income markets. The relative scarcity of capital serves to highlight the difficulties inherent in reliance on dealer capital to facilitate trading in secondary markets for corporate, agency and asset-backed bonds.

On both sides of the Atlantic, market and regulatory pressures are driving fresh initiatives aimed at transferring significant amounts of OTC dealer capital facilitated bond trading to central (exchange or alternative) trading facilities, supported by central clearing services. In Europe, the Cassiopeia Committee (with representation from buy-side and sell-side market participants as well as industry bodies) has published guidelines for the introduction of order-driven electronic trading platforms for corporate bonds. Already, two initiatives aimed at meeting the Cassiopeia Committee guidelines have been

announced for European corporate bond markets, while in the US, BNY Mellon recently announced the introduction of an electronic auction platform for asset-backed securities.

The resurgence of initiatives in the less liquid bond markets is a welcome sign of market vitality and potential for growth.

However, initiatives in the less liquid bond markets face a fundamental challenge; liquidity (or rather, a lack of liquidity) limits the scope for simple order matching platforms in the equity style. On a global basis, tradable fixed income issues run to the millions, compared to thousands of equity issues and only scores of currency pairs, presenting a limitation on the chances of a buy order meeting a sell order in a specific bond at a given time.

Fortunately, advances in technology and the emergence of sophisticated liquidity management tools are available to provide a basis for new and innovative approaches to overcome this limitation. At smartTrade we anticipate the introduction of innovative trading approaches through exchanges and alternative trading systems (US ATSS, European MTFs). We expect these new approaches to seek to better align the trading process with the investment process in fixed income, thereby facilitating execution of transactions on a portfolio basis, and significantly improving the potential for order matching. Innovation in the identification, aggregation and transmission of liquidity will





be required to drive these new approaches to transaction execution.

At smartTrade we view liquidity management as having five key components<sup>1</sup>. These are the building blocks necessary for the development of electronic trading in fixed income markets and for fixed income electronic trading participation in multi-asset trading strategies:

### **First key component: Aggregation.**

Liquidity may be available from a range of sources, both external and internal, and take a number of forms including orders, prices, quotes and requests. A key requirement is the ability to aggregate liquidity in a consistent format and to allow the user to determine and apply rules for crossing, order routing and best execution. In this way, the user can achieve full control over the sources of liquidity.

### **Second key component: Distribution**

An ability to provide on a custom basis information relevant to liquidity is essential. Distribution may be to internal users (trading desks, for example) or external clients and may encompass market data, price/spread information and trading limits information. Scalability is critical as custom matrices may be supplied to large numbers of clients.

### **Third Key component: Matching Engine**

An advanced matching engine capability is central to liquidity management. Speed and scalability are critical and the matching engine has to be capable of supporting a range of order types and execution criteria in a crossing, internalisation and custom dark pool environment.

### **Fourth Key Component: Order Routing Capability**

An advanced smart order router (SOR) capability is critical. The SOR needs to be able to reconcile “child” orders to original source orders and evidence best execution. Flexibility and full order lifecycle management are key requirements for SORs.

### **Fifth Key Component: Trading Connectivity Platform**

Connectivity to execution venues and other sources of liquidity has to be comprehensive, flexible and capable of seamless connection with differing formats and network protocols.

These five key components of advanced liquidity management form the pillars of the smartTrade Liquidity Management System<sup>1</sup>.

Advanced liquidity management tools will underpin the continuing growth and innovation



in fixed income electronic trading on a global basis. In the liquid fixed income markets, liquidity management tools will facilitate algorithmic trading and participation in multi-asset trading strategies; in the less liquid fixed income markets, liquidity management will facilitate innovation and improvements in liquidity available to order matching systems. Across the fixed income markets, advanced liquidity management tools will allow integration of differing trading methodologies (order matching, streaming prices, RFQ) across buy-side and sell-side institutions, broker-dealers and exchanges/alternative trading platforms.

At smartTrade we share the excitement for the prospect of new and innovative developments in fixed income electronic trading and look forward to the contribution advanced liquidity management will continue to make with market participants and execution venues.

*1 smartTrade Liquidity Management System (LMS) comprises the following five modules:*

**Liquidity Aggregator**

*This component provides aggregation of liquidity from external and internal sources and in a range of formats (orders, quotes, prices and requests). The capability allows firms to define and apply rules for crossing, order routing and best execution, achieving full control over available liquidity.*

**Liquidity Distributor**

*This capability allows organisations to create customised strategies for distribution of market data, pricing and counterparty limit management*

**Liquidity Crosser**

*Liquidity Crosser is an advanced matching engine, which can be used to create dark pools.*

**Liquidity Orchestrator**

*This is an advanced order routing capability, managing orders throughout their lifecycle and facilitating reconciliation of “child” orders to original source orders for proof of best execution.*

**Liquidity Connect**

*Liquidity Connect is a trading-connectivity platform with comprehensive connections to execution venues, handling differing formats and network protocols.*