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Digitisation shakes up corporate-bond markets
Greater automation promises more liquidity for investors
The Economist - Krister Koskelo
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JUST a few decades ago, an asset manager wanting to trade shares, bonds or derivatives almost always had to call up the trading desk at a big investment bank. Today shares and many derivatives can be traded with a few simple clicks (or even in fully automated fashion, using algorithms). But buying and selling bonds, especially corporate bonds, is still an old-fashioned business. Over four-fifths of trading in American corporate bonds still takes place with a dealer, usually over the phone. Yet digitisation is at last beginning to change the structure of bond markets: witness the announcement on April 11th by Tradeweb, an electronic-trading platform, that it is to offer "all-to-all" trading in European corporate bonds, ie, a system in which any market participant can trade with any other.

Electronic bond-trading is not in itself new. Tradeweb's platform, initially limited to trading of American Treasuries, was unveiled in 1998. Around half of Treasuries, and nearly 60% of European government bonds, are now traded electronically, reckons Greenwich Associates, a consultancy. But for corporate bonds, progress has been slower: only 25% of global trading volume in investment-grade bonds, and merely 13% of that in high-yield ones, is electronic. The market is huge—with over $50trn outstanding globally, and over $1.5trn-worth issued last year in America alone. But corporate bonds vary in maturity, issue date and in where they stand in the issuer's hierarchy of debt. Unlike, say, most sovereign debt, it is traded only rarely; 90% of all corporate bonds change hands fewer than five times a year. The shares of a company, by contrast, usually come in at most two types (common and preferred), and are traded frequently on centralised exchanges.

The traditional way of matching buyers and sellers has been for dealers to take on the risk. They name a price, buy bonds and hold them in their inventory until a buyer emerges. This explains why personal relationships still matter so much in the bond market. The model is deeply entrenched: even most electronic platforms have adopted it, in the form of "request for quote" (RFQ) systems, where dealers have the exclusive right to quote prices. But when dealers are unwilling to hold onto bonds, as many have been since the financial crisis, because of tighter capital requirements, then such systems offer no more help than phone trading. Some bonds trade so rarely that a sell- or buy-query may elicit no responses at all.

One new source of liquidity has come from exchange-traded funds (ETFs). Shares in bond ETFs, like those composed of equities, track indices, allowing investors access to a basket of bonds. But the impact for bonds is more significant, because bonds are otherwise traded so rarely. Indeed, bond ETFs are more liquid than the assets the funds own. But ETFs still need dealers: the institutional investors that create and redeem ETF shares have so far had to rely either on voice-trading or RFQ systems.

All-to-all trading, by contrast, has the potential to change bond-market dynamics more fundamentally. Pioneered in 2012 by MarketAxess, the second-largest bond-trading platform after Bloomberg, it allows any user of a network to trade with another directly, whether asset manager or dealer. Asset managers, who provide 39% of the liquidity in MarketAxess's all-to-all system, are thus in direct competition with dealers (who provide 29%). As Richard Schiffman of MarketAxess puts it, all-to-all makes it possible for asset managers to move from being price-takers (having to accept dealer quotes) towards being price-makers (setting their own prices).

We're all dealers now

Momentum is gathering as all-to-all catches on with other platforms, too. Smaller ones, such as Liquidnet and Trumid, already offer it. But Tradeweb's announcement this month carries particular weight because it is a sizeable force—the third-largest in the market, thus leaving only Bloomberg, the market leader, with no all-to-all offering as yet. At MarketAxess, the new system already represents 16% of trading volume in American investment-grade corporate bonds, and fully 34% of that in American high-yield bonds.

Some argue that even all-to-all systems, let alone RFQ, do not tackle one big difficulty: that buyers and sellers are not always present at the same time. Algomi, a bond-market data firm, seeks to match buyers and sellers across time. Its interface for dealers allows traders easily to keep track of inquiries into a particular bond; it also suggests similar bonds if that one is not available. For investors, the company provides data on trading activity in particular bonds. And for trades where a dealer cannot match buyers and sellers, it has, in partnership with Euronext, an exchange provider, set up a trading venue for corporate bonds that will link up dealers in its network. So dealers should be able to graduate from risk-taking to matchmaking.

Another factor that will change the structure of the bond market is regulation. From January 2018 MiFID 2, a wide-ranging European financial-market regulation, will require market participants to report the prices and approximate volumes of all completed bond transactions—an unprecedented level of detail (earlier American rules required more limited price disclosure). Such transparency is expected to weaken dealers' market power. The sheer complexity of this undertaking will also push more trading onto electronic platforms, which are busy embedding automatic reporting.

Amid all this change are tantalising hints of another potentially transformative trend: full automation. Tradeweb has already introduced a number of protocols that allow the preprogramming of a series of trades: eg, selling one bond and buying another with the proceeds; or arranging currency hedging. MarketAxess has even seen expressions of interest from hedge funds wishing to trade bonds using algorithms. Such moves have brought a lot more liquidity (and volatility) to other markets. In the sleepier world of corporate bonds, the impact could be far-reaching.

Read more: http://www.economist.com/news/finance-and-economics/21721208-greater-automation-promises-more-liquidity-investors-digitisation-shakes-up