The Changing Shape of Derivatives Markets

Frontiers Between On- and Off-Book Markets

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Frontiers Between On- and Off-Book Markets

As electronification gains pace, transparency and the need for rigorous compliance remain key considerations, all while market participants strive to compete.

As the central limit order book (CLOB) and off-book—whether through the traditional call-around market or in the request-for-quote (RFQ) space—increasingly vie for business, the market structure looks ripe for disruption.

As several exchanges develop solutions to open up the CLOB to more flow, seemingly supported by market makers and the sell side, where will the new frontiers between on- and off-book trade sit? And who will be responsible for setting these new frontiers, as more participants court end clients for their business?

The traditional telephone-based market structure has been based on a relationship between the sell side—the banks and the market makers—and the interdealer brokers (IDBs) arranging the trades. The buy side has hitherto been indirectly represented via the bank.

"But in recent years, all of these stones have been moving," says Eurex executive board member Randolf Roth.

The rise of electronic trading platforms has propelled the market, as more players are trying to establish direct relationships with the buy side. Enabling them to strike a balance between price discovery and signaling risk is a delicate task.

Eric Böss, Global Head of Trading at Allianz Global Investors, sees pros and cons to the shifting sands. "My counterparts have become more heterogeneous as a group, still comprising banks but also including ELPs [electronic liquidity providers] and, in some cases, peers—though this is not that big in derivatives, yet."

FROM **50%** > TO **70%**

Eurex has ambitions to grow the boundaries of the central limit order book from 50% of volume to 70%.

While a more diverse set of counterparts is generally a positive, on the flip side, the situation for the off-book market has not moved on to the same degree. For large risk transfer trades taken off-book, the buy side is still fairly limited in terms of counterparts, forcing a reluctant showing of hand.

The more participants meeting in a marketplace, the less fragile it becomes. Pre-Lehman Brothers, the market was largely divided into banks and clients, and that binary state was arguably a contributing factor to the system's collapse.

Today, we see a more complex mix—from a growing number of hedge fund-like strategies, ELPs and banks, to a buy side that not only includes asset managers, insurance companies and pension funds but also covers sovereign wealth funds, family offices and private banks—all opening up plenty of arbitrage strategies between asset classes.

"The fact that there are more players out there potentially does not necessarily help the banks," Böss says. "But for me, I look for a stable, diversified and heterogeneous market. It's like an ecosystem; the more complex an ecosystem, the more stable it is."

While sentiment seems unanimous regarding the benefits of a fuller, more liquid and transparent CLOB, it might be easier said than done.

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RANDOLF ROTH
EXECUTIVE BOARD MEMBER, EUREX

"It is a difficult task because you are trying to optimize several inputs," says Böss. "What's the optimal block trade size that pushes as much volume as possible on the CLOB without keeping it from trading at all?"

The industry is divided, as some banks acknowledge that the world is headed toward greater transparency, and they anticipate tighter regulation with a shift toward increased block sizes as a way for the sell side to differentiate in the market.

"You could argue we are trying to push the boundary of the order book further out through larger block sizes and a bigger share going in the order book," says Roth. "On the other hand, the order book always has been very efficient. It has straight-through processing, compared with the call-around market that is much more cumbersome."

Roth argues that with the rise of electronification, the off-book will become more streamlined, potentially eating away at the efficiency advantage of the CLOB. "As the off-book market becomes more electronic, it becomes more efficient, and therefore there may be less of a need to go on the order book," he says.

Given the order book's dominance by algorithms, many end clients are turning to it as a price discovery mechanism to then benchmark their trades in the off-book market.

While Eurex has ambitions to grow the boundaries of the CLOB from 50% of volume to 70%, it looks like the CLOB and request-for-quote models will coexist for the time being; both have a role to play. While keeping trade off-book may not be as accountable to the rules and rigor of an exchange, with that comes a degree of flexibility and freedom in pricing, and in setting limits that best serve the needs of both participants. On the flip side, off-book can be seen as higher risk in terms of counterparty default, with fewer restrictions in place.

Technology compatibility is one of the primary hurdles for market makers, determining whether or not they can compete effectively on the CLOB; those that cannot tend to focus on the call-around market. The second challenge, especially given the industry's drive toward greater transparency, is tackling the volume of equity products currently taken off-book and internalized—when a proprietary trading desk faces the client directly and only brings the concluded trade into the clearinghouse.

Roth explains how pressure on the banks' commission structures means the appetite to internalize trade is still strong. "Internalizing flow is riskier, but it also provides a much bigger margin," he says.

What will it take for the market to shift from call-around to the CLOB—will it be regulatory forces or natural market movement?

While a degree of reticence will ultimately come from the buy side, due to not wanting to reveal their price, more often it will come down to liquidity. If even some of the more traded segments of the OTC derivative market are simply not deep enough to honor larger trades, more esoteric products have no chance of moving over to the book—not yet.

"People talk about liquidity as if it was one number, but the reality is that liquidity for a retail investor and for a wholesale investor like us is a very different animal," adds Böss.

As bid/offer spreads in the more liquid markets have tightened, he says order books have become thinner, so while smaller investors can trade at tighter spreads, for a player like AGI, there is the issue of making a larger market impact.

As the boundaries blur between each market participant's role, new frontiers are inevitable, but it remains to be seen what this will look like and how long the evolution will be. Will the greater transparency of the order book be enough to outweigh its premium pricing and lack of flexibility?

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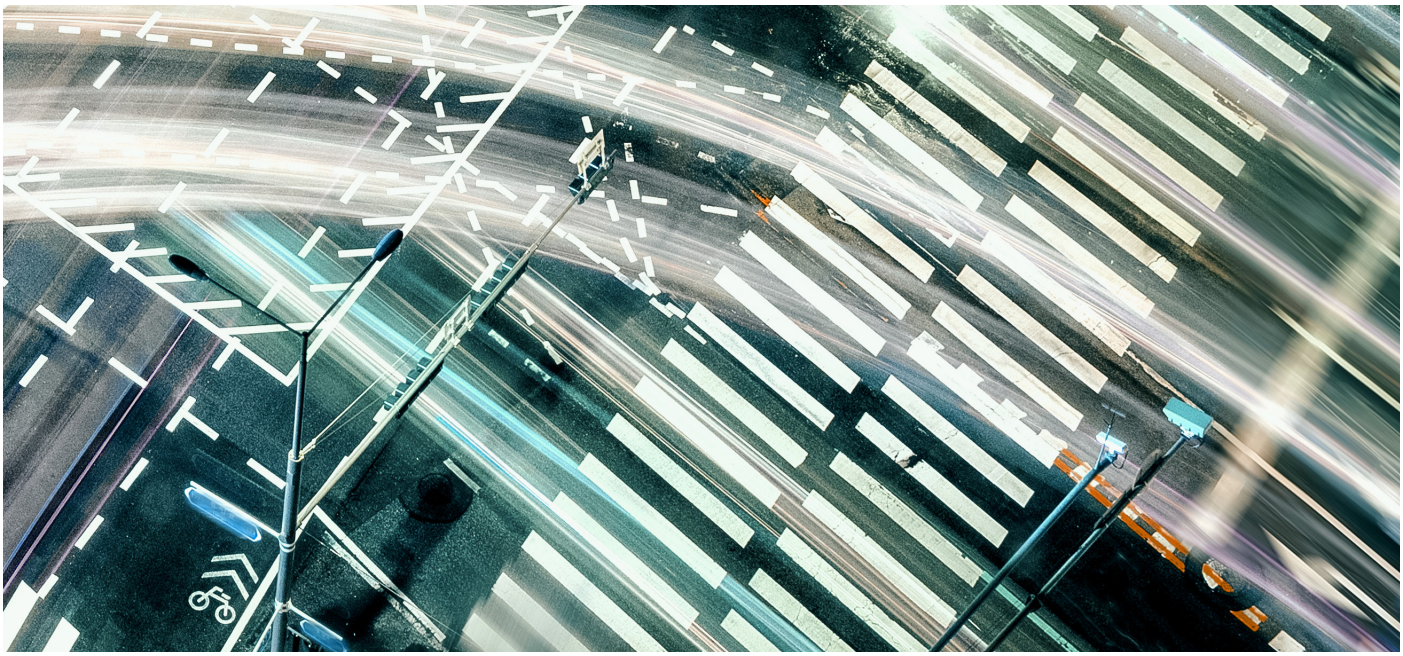
ERIC BÖSS
GLOBAL HEAD OF TRADING, ALLIANZ GLOBAL INVESTORS



The Changing OTC Derivatives Market

Before 2008, the over-the-counter (OTC) derivatives market was renowned for its opacity. Typically traded over the phone and largely unregulated, it became apparent at the start of the global financial crisis that change was needed.

In recognition of the characteristics of the OTC derivative market and their role in the collapse of the global financial system, the Pittsburgh G20 Summit on Financial Markets and the World Economy in 2009 crystallized the intention for reform agreed upon by leaders across the developed world. Mandating the reporting of derivative contracts laid out the commitment to improve the transparency and resilience of the market.

In the EU, this intention was codified in 2014 into European Market Infrastructure Regulation (EMIR) Article 9, which states: "Counterparties and CCPs shall ensure that the details of any derivative contract they have concluded and of any modification or termination of the contract are reported to a trade repository."

While the overall market has grown 20% since then, option volume actually declined while futures volume grew by more than one-third, according to Eurex.

The past 10 years has witnessed the rise of non-bank market makers—predominantly electronic liquidity providers (ELPs), the former high-frequency traders (HFTs)—which can be attributed to two major factors, the first being regulation. As a result of the Dodd-Frank Act and generally higher capital requirements, the cost of market making has become more expensive. The second factor—arguably in response to tighter regulation—is that third-party firms are running leaner technology, made cheaper because they are regulated in a less onerous way than the banks.

"They have harnessed that advantage, which regulators put in their lap," says Eric Böss, Global Head of Trading at Allianz Global Investors.

As technology advances to improve speed and efficiency as well as transparency, the industry continues to debate the roles of off-book trade execution and the traditional request-for-quote (RFQ) model. Both allow participants to select their approach depending on instrument type, size of trade, particular counterparty and prevailing market conditions.

The RFQ model remains relevant; it adapts pricing that maps to individual trading positions of a selected group of trusted counterparties, but arguably forces the end client to reveal their identity, as well as the size and position of their trade.

The CLOB is broadly understood to have opened access between the order originator and the market maker, improving price discovery potential while allowing the originator to retain anonymity.

In mainstream equity index markets, large orders can be sliced into smaller-volume orders, potentially on different exchanges, to aid liquidity while shielding the origin of the order. In the derivatives market, the tendency toward a single exchange per product means that particularly large orders have no alternative but to go off-book. To address this, Eurex developed their Eurex EnLight platform.

Since MiFID II "best execution" rules came into effect, people are now looking at this issue much more closely than they have historically.