Risk

Appetite for disruption

RFQ pioneer is embracing new protocols and liquidity providers in a bid to connect the OTC markets. By Kris Devasabai

Amid a crop of disappointing tech IPOs, Tradeweb's stock market debut in April felt like a coming-of-age party, heavy with symbolism and bursting with promise.

The company, which launched its first electronic trading platform in 1998 with financial backing from a consortium of banks, has long been viewed – and sometimes maligned – as a hostage to the interests of big dealers.

Much has changed since the early days. Thomson Financial acquired the company in 2004 and later sold a minority stake to a group of banks in 2008. Last year, Blackstone bought a majority stake in Thomson's finance and risk business, renaming it Refinitiv, and spinning off Tradeweb in the IPO. Refinitiv, which is being acquired by London Stock Exchange Group, remains the majority owner.

Through it all, the 'bank-owned' tag has stuck.

"That sticks in people's heads, and it's a bit of a branding challenge," says Lee Olesky, co-founder and chief executive of Tradeweb Markets. "And in some ways, it's one of the many reasons going public made sense, to eliminate that vestige of old thinking."

It seems to have had the desired effect. When market participants are asked to speculate about the strategic priorities of the post-IPO Tradeweb, they suggest the platform may now have the freedom to expand in ways that would be more disruptive to bank market-makers. One suggests a foray into foreign exchange, and a second wonders whether Tradeweb will be tempted to acquire one of the many forex venues that have sprung up in recent years.

But Olesky insists the "old thinking" about bank ownership was swept away long before the IPO by the twin trends of regulation and digitisation.

Post-crisis regulations such as the Dodd-Frank Act pushed a big chunk of over-the-counter derivatives trading onto electronic venues, transforming Tradeweb's business. After launching electronic trading in swaps in 2005, "it took us years to get up to trading a billion a day," he says. "We now trade $280 billion a day."

Biography – Lee Olesky
2002–Present: Chief executive officer, Tradeweb
1999–2002: Co-founder and chief executive officer, BrokerTec
1996–1999: Co-founder and chairman, Tradeweb
1993–1999: Chief operating officer, fixed income, Credit Suisse First Boston

Rates heavyweight

The forced electronification of derivatives trading had knock-on benefits for Tradeweb's other products and markets. "People start using the platform for mandated products and they say 'Why wouldn't we use it for other things?' It converts people over time," says Olesky.

That's borne out by the numbers – to a degree. Tradeweb's average daily volumes, across rates, credit and equities, have grown at a compound annual growth rate of 22.5% over the past five years, to $815 billion in the third quarter of 2019.

But rates products – government bonds, mortgage bonds and interest rate derivatives – still make up the lion's share of those volumes; in the third quarter, they accounted for 69% of ADV, with repo and other money market products making up a further 28%.

Credit and equities trading on the platform may be growing rapidly, but it still represents a small slice of the total.

Regulation has been far less favourable to the big dealers that first bankrolled Tradeweb. New capital, liquidity and leverage rules have made it more expensive for them to carry inventory and take principal risk. Several dealers have pulled back from fixed income and derivatives trading as a result.

Olesky says the retreat of bank liquidity providers has been offset – at least partially – by advances in technology, which have made it easier for new entrants to fill the liquidity gap.

"There's more of a challenge with respect to balance sheet and the provision of liquidity at big banks because of the regulation that's come into play," he says. "But there's also been an evolution of technology that has allowed other players to quickly catch up, and in some instances, even surpass banks in terms of providing liquidity more efficiently."

Tradeweb's IPO allowed some banks that have been pulling back from fixed income trading to reduce their stakes. Two dealers – Royal Bank of Scotland and UBS – exited entirely.

Bank ownership fell to 17.3% after a follow-on offering in October – down from 46% before the IPO. Public shareholders – led by large asset managers such as BlackRock, Invesco and T. Rowe Price – now hold 28.7% of the company stock, while Refinitiv maintains a 54% majority stake.

That ownership split better reflects the diversity of market participants active on Tradeweb's venues. The company has around 2,500 clients, comprised of banks, asset

Photos: Tradeweb

managers, insurance companies, proprietary trading firms (PTFs), retail brokers and central banks. And more of those clients are becoming price makers, as well as price takers.

"There are plenty of bank liquidity providers that are huge market participants. And we expect they will continue to be huge market participants. There are also a number of new entrants," says Olesky. "Everybody has more robust technology at a lower cost, and so they're able to operate in a very different way. There are different types of market participants that are providing liquidity now. You have PTFs, different kinds of banks, buy-side firms are making prices."

In US Treasuries, where Tradeweb started, "we've seen PTFs become real liquidity providers, even to banks," he says.

In other markets, PTFs were a force long before Tradeweb got there. The company launched its electronic OTC trading platform for European exchange-traded funds (ETFs) in 2012, which now sees more volume than any of the equity exchanges in Europe. It also began trading US ETFs in 2016. PTFs are the main liquidity providers in the product.

"In ETFs, certain PTFs have a real lead because they were first movers in providing liquidity and figuring out how to hedge and interact with markets," says Olesky. "That's happened in other markets, like equities and foreign exchange."

Olesky doesn't believe the emergence of non-bank liquidity providers in OTC market-shas fundamentally altered Tradeweb's business model, which he compares to that of another tech company that made its debut in 1998 – Google.

"What we've been doing all these years is essentially search," he says. "We're a big network deployed all over the world and integrated into the technology of financial institutions. And when they trade, what they're doing is searching for the best price to buy or sell something."

"In ETFs, certain PTFs have a real lead because they were first movers in providing liquidity and figuring out how to hedge and interact with markets" Lee Olesky, Tradeweb

Crossing the streams

What has changed are the methods, or protocols, that Tradeweb's participants use to discover, negotiate and agree prices. The request-for-quote (RFQ) model the company started with – and which still accounts for the bulk of its volume – replicates the phone calls through which most fixed income products have typically traded, with clients inviting liquidity providers to price their orders. As Tradeweb has attracted more liquidity providers and clients, the range of protocols has also expanded.

"We started with RFQ, and if you fast-forward 21 years, we now have a very wide range of protocols – ways that firms can search and interact with counterparties," says Olesky. "We have RFQ, we have order books, we have streaming prices, we have inventory models, we have all these twists and turns. That has been part of the innovation and application of technology to accomplish a more efficient search and workflow."

Direct streaming is arguably the most disruptive protocol to hit the fixed income market in recent years. Under this model, pioneered by PTFs, liquidity providers stream executable prices directly to clients, circumventing platforms that connect buyers and sellers. Direct streaming accounted for nearly 10% of US Treasury volume in the second quarter, according to Tradeweb estimates, from practically zero five years ago.

Originally perceived as a threat, trading venues have learned to embrace direct streaming. Tradeweb began offering direct streams to dealers, market-makers and PTFs in 2017, via Dealerweb, its interdealer platform.

The service has been a hit. At the end of October, seven liquidity providers were streaming firm, executable prices for on-the-run Treasuries, trading in 1/16th price increments across the curve. The list of streamers includes prominent PTFs, such as Jump Trading, Virtu and XR Trading, alongside big banks, such as Citi and JP Morgan. Around 40 firms are taking in those streams via Tradeweb, including 20 out of 24 primary dealers in US Treasuries.

In July – not long after the IPO – Tradeweb went further, offering direct streams in on-the-run US Treasuries to institutional investors.

As with so much else in financial markets, Olesky says direct streaming was made possible by advances in technology. "What's happening is, the ability to provide live, two-sided prices in markets is enhanced by the risk management technology that's available today. As technology gets more and more sophisticated, firms are able to essentially manage hundreds of order books. They're able to manage what happens if they get hit across 100 order books to the tune of $100 million, and they're suddenly long $10 billion. They're able to manage that with the software available today."

And that has benefited clients. "What that does is, it makes for a more efficient price discovery and a better price that's available out to the market, and more certainty because they're live prices."

Nor does Olesky see direct streaming as a threat to venues such as Tradeweb. He argues platforms can allow consumers of liquidity to more efficiently access price streams.

"We're able to deliver a more efficient connection into streams, with all of the advantages of a bilateral stream."

In that respect, Tradeweb's slant on streaming is not so different to what it did with RFQ in the early days. "Prior to Tradeweb, banks had direct connections to their customers via Bloomberg. But ultimately, it was more efficient for those customers to have all of that in one place," he says. "For a streaming provider, it is easier and lower-cost to come to Tradeweb and effectively have a wheel and spokes going out."

So, could streaming, which started in forex before coming to US Treasuries, work in OTC derivatives? Perhaps, says Olesky.

"I'm sure some firms can stream swap prices. I'm sure some do live, executable prices. But swaps is not as high velocity as Treasuries. It tends to be more bespoke, with specific sizes and tenors," he says, adding: "Over time, speed keeps accelerating, and firms will be able to provide more and more live prices across a spectrum of instruments. Some users will want that, and we'll be in a position to deliver that."

Joined-up thinking?

Tradeweb's current focus is on developing tools and services that allow users to cut costs and improve efficiency. "Reduction of cost is probably, first and foremost, the biggest driver among all our customers," says Olesky. "Every client is under cost pressure."

Big banks need to preserve their profitability as margins or volumes shrink. The buy side is now facing similar pressures as investors continue to pile into low-cost ETFs and passive funds. "We're in a good spot because we're a technology firm, and that's the first place you look when you're trying to reduce costs," he says.

To that end, Tradeweb launched a tool called AiEx, which allows buy-side firms to automate a chunk of their order flow across a variety of credit, rates and equity products.

But Olesky says bigger efficiency gains could come from linking the different markets in which Tradeweb operates. "The markets are all linked. You might trade corporate bonds, but you're looking at the equity markets, forex, you're looking at all the marketplaces. Having digital connectivity between markets is critical."

This is something he believes Tradeweb can do better than its rivals, such as Bloomberg, BrokerTec, Nasdaq Fixed Income and MarketAxess. Many of these platforms are only "in segments of the market", he says. "What's unique about Tradeweb is, we're actually across the board. We have a variety of different client segments, from retail to wholesale and in the institutional business, and our Treasury offering cuts across each of those segments."

Some of Tradeweb's competitors have been expanding their reach into new markets through mergers and acquisitions. CME's purchase of BrokerTec puts the Chicago-based exchange operator in pole position to link the cash and futures markets in Treasuries. And corporate bond specialist MarketAxess is entering the Treasury market via the recently completed purchase of LiquidityEdge, a streaming platform.

Olesky is unperturbed. Tradeweb has "the widest reach of all the different customer segments" and is active in a wider range of products and markets than its main competitors, he says. "If you look at our volumes and our business, [Treasuries] started off as our core product, and it is a very critical product or asset class. But we've got dozens of those products now. It's a much broader business than just Treasuries."

And Tradeweb has already started to connect some of those products and markets. One example of this is its portfolio trading functionality for corporate bonds, which it expanded in October. In a portfolio trade, multiple bonds are packaged into a single basket and executed as a single transaction at an all-in price.

Much of this activity is linked to fixed income ETFs, which allow liquidity providers to quickly source or offload bonds through the create-and-redeem process.

Similarly, Tradeweb's net-spotting methodology enables users to automatically source and price interest rate hedges for corporate bonds in the US Treasury market. It also has a service that allows investors to create packages of asset swaps, combining swaps and government bonds, and executing them in a single trade.

"Having digital connectivity between markets is critical," says Olesky. "You see us doing that with portfolio trading in credit. We're combining hundreds of bonds and allowing for a trade on that. We're linking the corporate bond and Treasury markets for spotting, where Treasuries are a hedge for the corporate bond. We've taken asset swaps, where you take a bond and link it to a swap to switch the coupon from fixed to floating, and linked those markets so you can do it electronically."

And while it works to reduce costs for struggling financial firms, Olesky sees no shortage of growth opportunities for Tradeweb.

"There's a huge amount of opportunity for us as we expand into new asset classes, with new functionality, and connect all the dots," he says. "The average daily volume in the markets we're in is $6.5 trillion a day, and we're doing around $800 billion of that. But there's plenty of room for more electronification. Swaps are anywhere from 30% to 50% electronic. Credit is similar. Even in US Treasuries, 40% of the volume is still not electronic. The evolution of the market into a completely digital environment will absolutely happen, it's just a question of how quickly." ■

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