Eurex: the changing face of liquidity after COVID

Panellists in a Eurex webcast explore the new liquidity provision architecture after the pandemic, the changing dynamic between the buy-side and independent market making firms and examine which participants will make up the new market eco-structure. Carmella Haswell reports

Panellists

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What was your experience during the pandemic and what lessons did you learn regarding liquidity formation?

Robert Miller: From an equity perspective, we're well enabled to adapt our execution strategy due to the quality of data and the speed of turnaround to get that information back to the desk. Despite fill sizes reducing on the equities side, they reduced significantly less with the electronic liquidity providers (ELPs) compared to other venues we interacted with. From a fixed income perspective, we saw our traditional providers take risk off and reduce balance sheet capacity, which created an opportunity for other alternative liquidity providers to step in.

The greater use of automated workflows and technologies aided a quicker and clearer picture of the current trading landscape. There are now more calls and planning protocols at our disposal to help force liquidity. As a believer in innovation, I initially thought the pandemic would slow this down. However, the opposite seems to be true. The new participants we're seeing come to the market have increased the ability for us on the buy-side to help automate some of our workflows.

Mike Kuehnel: We have seen technological advancements in global financial markets for several decades and what COVID has brought into the game is resetting the core. From a market maker perspective, innovation can lead to greater data availability and improved allocation mechanisms, creating more resilience, speed and reliability. The observations, specifically in 2020, are just the beginning of a bigger change to the market structure, leading to better connectivity and greater transparency.

Technology and innovation is enabling us to reduce transaction costs down the road. As these benefits become more apparent, I am sensing a high degree of appetite among market participants. However, by looking into optionality, availability, and by systematically understanding these options, they can create access to wider pools of liquidity and different venues, optimising liquidity access from a buy-side perspective.

Jonas Ullmann: At Eurex we saw that in the crisis there was a flight to quality and if you look at a situation with such high volatility, the offered sizes and spreads reduced compared to a time where volatility was at 10 or 15 points. If you look at the volumes that had been executed, though, these were very significant. Liquidity was there, even if you haven't been able to see it immediately on the BBO level. Looking at the different markets and how they reacted, for example, with fixed income options we saw that markets partially switched away from the order books and instead entered traditional offbook markets, which were supported by electronification and digital platforms.

On the other hand, if you look into our Euro Stocks Futures book, right in the middle of March, where things got massively crazy with minus 10 per cent, this calendar roll was nearly completely done in the order book. In such crisis times, quality was clearly key and the electronic liquidity providers remained in an active role in the order books, but also supported our clients in the offbook markets.

Piebe Teeboom: I think agility played a key role here: the flexible setup of electronic market makers as firms trade with their own capital, able to make the necessary changes with the changing market conditions and working from home without impacting internal workflows or processes. All this meant that they could continue to provide liquidity to end investors. More broadly, it reflects the adaptation that has taken place, which intensified over the last two or three years, to changing demands from the market, in particular, the buy-side.

What were the lessons learnt from the crisis that the industry is taking forward?

Miller: The ability to constantly evolve and adapt was a learning curve for us, especially in such uncertain times. In order to move your execution strategy forward, you need to have a good data infrastructure and base level to where you are able to analyse what's going on, measure it, work out what impact that's having on your flow, and then adjust your execution strategy to that.

We aim to be – and can be – more fluid compared to how we were previously. From the lessons that we learnt in COVID, we reflect back to the financial crisis, and seemingly, market behaviours haven't changed with spreads increasing and volumes decreasing. We can learn from the past crisis and apply it to what we see now.

Kuehnel: We have a clear indication of the changes we're now seeing: electronification; availability of more data and converting this into insights; automated trading to a higher resilience in global financial markets; improving the asset allocation for the buy-side. Ultimately this is also affecting entire trading processes and improving trading strategies.

We work to understand how technology needs to move further into the middle, while also having a constant exchange and ecosystem dialogue to discover where the benefits lie for market participants and how this ecosystem can evolve. In addition to acceleration, there is an increased level of transparency — understanding who is able to deliver what and where the key pain points have been in the past. We are now at a point where new functionalities, such as portfolio trading are coming in, where market makers are able to quote a bigger portfolio of funds in seconds.

Firm pricing is one of the key elements in fixed income. We want to build on this further and have embraced this technologically. I think that is probably one of the biggest innovations we have seen. I will argue that even higher ticket sizes will be affected by firm prices. There's a natural evolution in creating higher confidence among the buy-side to embrace it.

Ullmann: There's different sizes and different demands from market participants and straight-through processing (STP) is clearly important. People would like to evolve from a market where you're limited from a transparency perspective to only a few parties, to a model which is more sustainable and allows you to automate your processes and deal efficiently with selection of execution.

Cooperation with both market participants and other execution platforms and technology providers has significantly increased. We are in close engagement with many of those parties to make sure that we at Eurex facilitate price discovery, but also other providers get the opportunity to offer services that we can cooperate and partner with. For the benefit of the end client, being able to execute how they would like to execute with respect to transparency, and seek liquidity where necessary, is key.

Teeboom: I think an important role was played by the increased direct engagement between my members, as market makers, with the buy-side community, taking them more in-depth into the ways they provide liquidity and how they can hedge. I think that is underpinned by better understanding and steps to embrace technology more fully. Our members have already done that and this has been on the increase for many years. That created a positive cycle which enabled further improvement in an iterative way, in an open, interactive dialogue between market makers and the buy-side.

With market infrastructures like Eurex playing an important role, this has driven diversity in the market, providing more choice for the buy-side. Ultimately, that adds to the resilience that we want to have in the market. I think it is also important from a public policy point of view that we do see a positive impact from several MiFID II reforms. In particular, pre-trade transparent RFQ systems, which have been incentivised by MiFID II and the research and execution unbundling rules, have unleashed the ability for the buy-side to trade where they want to.

What will future liquidity formation look like?

Miller: Revisiting what we saw in the equity markets after the financial crisis of 2008, the industry has evolved during this period. Specifically, it has become increasingly electronic and the buy-side has improved its data analytics, creating an environment where innovation and change could be measured. So was COVID the trigger point for the fixed income markets? Whilst data quality is still an issue, things are moving positively forward and that will hopefully provide a foundation that will enable increased innovation in the fixed income markets.

The use of exchange-traded funds (ETFs) has increased the ability for alternative liquidity providers to quote more effectively when it comes to portfolio trading. This has many benefits for us — for example, strong risk management, improved efficiency and more competitive pricing, especially from a part of the basket that may be considered illiquid when traded separately. It also helps minimise information leakage and that wouldn't be possible without the introduction of ETFs.

Kuehnel: To increase the access to inventory and make markets more efficient, there is a need to systematically improve asset allocation. Non-bank liquidity providers, such as Flow Traders, have also diversified across various asset classes. The increase of electronification — not only when it comes to fixed income, but also crypto and at some point digital assets — will also impact the asset landscape. In addition, I think the availability of higher-quality data and technological advancements enable us to better translate this in terms of pre-trade and to optimise decision-making.

I would argue that people fell in love with optionality. The old picture was centring on a multi-services perspective, so now it's very much more transparent and the willingness to have strategically more optionality, not just in light of turmoil, but also in light of finding the best channel, the best liquidity pool and having just the ability to execute wherever you want to. I think that flexibility for asset managers is a big plus and the entire market on that front has become more viable. If market participants understand how to effectively use technology systems then, as a result, this can deliver reliable prices and create resilience in the system.

The end game brings us to fully transparent markets, low transaction costs, the ability to move capital around based on your preferences without any hurdles and boundaries. Ultimately, you need to have an end-to-end infrastructure in place to make it happen and bring the regulator in to make sure that they understand the benefits down the road. I'm mindful that an isolated discussion on crypto is not clear because we're talking about the structure and evolution into digital assets and tokenised liquidity pools, which will have a massive impact on global financial markets. However, I do believe that if the regulator and market participants are taking the right care in developing that over time, there will be benefits for the retail and institutional side. Without institutional flows, it will be tricky to further embrace innovation, so it needs to go hand in hand.

I like the thought of the regulator being an architect in this process because the regulator deserves that role, with a forward looking mindset, understanding how innovation can impact not just fixed income but all market structures around us. Another dimension would be to understand how a regulator could accelerate the change. This is about constant communication and understanding that we need to work together — and the availability of data is one of the biggest challenges. But I believe we will reach a point where there will be alliances around the world emerging in order to tackle this data issue more systematically, because the benefits will be there for all market participants and investment decisions.

Ullmann: If you look at the products that we're trying to futurise, Total Return Swaps for example, that has been a typical product in the past that was dealer driven. We see now that these products don't just futurise to the exchange and behave, from a price discovery perspective, similarly to how the TRS has done in the past. Instead we have new players emerging and closely cooperating with the buy-side and the banks. Still, the banks have played an important role in 2020 — choice, diversity and transparency is something that we have clearly seen at Eurex. For asset classes that typically haven't been traded electronically in the past, we wish to get these at the same level. That is something that we want to facilitate and support.

More broadly, we want to move with our participants and our regulators to shape the financial future together. At Eurex, we aim to remain competitive worldwide when it comes to innovation and financial markets. If we look at the retail business, we have seen neo-brokers play a significant role throughout the pandemic, even more so in the US than in Europe. There's more transparency and technology required, but we've certainly laid the foundation in that regard.

Teeboom: The need for data is clear. The electronification of fixed income markets means that you will need data to navigate. An important requirement is to understand, where does liquidity sit? How does that shift? I think in that sense for the fixed income markets, the consolidated tape will provide a real benefit to end users. It is important that policymakers take note of these recent developments and we've seen many proof points. In both the EU and the UK, we are reviewing the relevant rule books. It is important that regulators and policymakers take good note of this and seek to play their role. This is also key in enabling the markets to be as efficient as they can be for the end investor.

What is your ambition for the capital markets over the next decade?

Miller: My ambition for the capital markets is to enhance data quality, there are five stages towards a more data-driven market eco-structure. The first one is data denial, where there's an active distrust of data; the second is data indifference, where there's no interest in data; the third stage is data aware, where you are collecting data for monitoring but you don't base decisions on that data; fourthly there is data informed, using selective data to aid some decisions; and finally there is data driven, where data is playing a central role in execution strategy. Different asset classes are at different stages in this data driven eco-structure – what would it take to get fixed income data quality to a level where everyday execution decisions can be made using data.

Kuehnel: We are dreaming about transparent markets, low transaction costs, full transparency, so coming back to the point on data-driven environments and having a key understanding of how data can improve asset allocation on a global basis. We will potentially see the digital asset space becoming quite dominant over the next decade. We will also see a larger universe of assets becoming available for trading and investment, with asset managers tapping into tradable illiquid assets, for example private debt.

Ullmann: We have proven that financial markets and Eurex can facilitate price discovery and enable price formation, finding buyers and sellers. We believe we've achieved this in the financial markets with different asset classes at different stages. Securities are very different, but in five or 10 years we're in a position where this is expanding into other asset classes, geographies, and of course, across a 24/7 trading day. When it comes to trading, when it comes to clearing, there needs to be a place where all of this is done.

Teeboom: What we really want to achieve is a European capital market that achieves better outcomes for the economy, society and therefore the end investor. What is needed is a fully integrated single market in the EU for financial instruments. At the moment, it is still very much fragmented. We are underutilising opportunities that are there to create that integration — going back to the consolidated tape for example. That is one of the key reasons why we are so supportive of that. And I think we're also underusing the ability of market makers to drive those outcomes for investors.