

No rest for the brokers

The crisis in the financial markets has meant the leading interdealer brokers are busier than ever. But despite the change in market conditions, many of the themes – in particular, consolidation – are identical to previous years.
By *Radi Khasawneh*, with research by *Xiao-Long Chen*

The largest brokerage firms dominated *Risk's* 2008 interdealer brokers survey, highlighting that when the market is in crisis, flow consolidates around the biggest names. London-based Icap won 28 of the interest rate categories, down one from last year's 29 first-place wins, but 16 more than its nearest rival, Tullett Prebon, which won 12 interest rate categories. In currencies, Tradition-Icap took first place with eight wins versus seven for Tullett Prebon.

Meanwhile, New York-based GFI further increased its dominance of the credit derivatives sector, winning 15 of the 16 categories, while London-based specialist equity broker Sunrise dominated the equity derivatives segment, taking first position in 19 of the 23 categories.

The disorder in the financial markets has hit dealers hard, with the top firms forced to write down billions of dollars in US subprime mortgage-related positions. In contrast, interdealer brokers have generally benefited from the high-volatility environment, with many seeing increased business over the past year. Icap, for instance, reported an 18% increase in group revenue to £1.3 billion in the year ended March 31, 2008, with pre-tax profit up 31% to £330.2 million. Group revenue in the second quarter rose a further 15%, the broker said.

"It has been a very intense period for all concerned, but it's just a case of doing what you do well and concentrating on the market. We have seen periods of frenzy interspersed with times of inactivity, with the momentum of the market shifting from one extreme to the other almost instantaneously. In these situations, the leading interdealer broker will get the biggest share of the market," says David Casterton, chief executive for Europe, Middle East and Africa at Icap in London.

The firm has seen strong growth on its electronic broking platforms – a key factor in its success, says Casterton. Icap's average daily e-broking volumes increased by 7% in the second quarter compared with the corresponding period last year, to \$825.5 billion. Meanwhile, average daily spot foreign exchange volumes on its EBS platform reached \$213.4 billion in the quarter, 40% higher than the second quarter of 2007.

The broker has also extended its presence in equity derivatives, completing the acquisition of specialist brokerage Link in April. This comprised an initial payment of £156 million, along with a deferred payment equal to 25% of nine times the profit after tax for the year ended March 31, 2010, of the Link group after it has been merged with complementary Icap businesses. The total fee is capped at £250 million. However, the acquisition was not enough to force Icap on to the leaderboard for equity derivatives.

"Having already gone through the consolidation process and made the necessary investment in technology, the breadth of our coverage enabled us to operate successfully in these unprecedented market conditions," Casterton says.

The difficult trading conditions were perhaps most acute in credit derivatives. At the height of the crisis, liquidity evaporated in parts of the credit default swap (CDS) market, while new collateralised debt obligation issuance virtually ground to a halt.

Nonetheless, the over-the-counter CDS market has increased overall, reaching \$62.2 trillion in notional outstanding at the end of 2007, according to the International Swaps and Derivatives Association – a rise of 37% from the end of June that year.

Much of that activity has come from increased hedging, restructurings and unwinds, with a large proportion of this flow going through the interdealer market. “There has been an environment of consolidation within the banks, with senior management looking to traders to cut down their risk and lay off positions quickly. That means a higher churn rate in terms of trades,” says Colin Heffron, president of GFI in New York.

GFI is the latest firm to be caught up in the wave of consolidation sweeping through the broker market. On July 31, it announced it was engaged in non-exclusive discussions with Tullett Prebon regarding a possible tie-up. No further details were available as *Risk* went to press.

“I think consolidation is being driven by the demand for technology. All those things cost a great deal of money to build and the people who have invested in them are leading the march on that,” says Heffron. “To afford to continually build new electronic platforms takes a lot of investment, so you are better off being bigger because you can support that

investment more than if you are a smaller firm. The expense of that technology is driving some of that consolidation.”

Technology was the reason behind the merger of BGC and eSpeed (an electronic trading platform owned by BGC’s parent, Cantor Fitzgerald), which was completed in April this year. The combined group – known as BGC Partners – offers a fully electronic and hybrid platform, which saw notional volumes of around \$121 trillion in 2007, up 24% from the \$98 trillion in 2006.

“eSpeed’s technology has been used by BGC since the company’s inception three-and-a-half years ago,” says Shaun Lynn, president of BGC in London. “In fact, eSpeed has now invested more than \$1 billion in new technology since it was formed, and BGC will continue to see the benefits. We have seen some great synergies between the two since the merger.”

BGC appeared on the leaderboard for interest rates and currencies, performing particularly well in inflation. However, it has yet to challenge the likes of Icap and Tullett Prebon. “BGC is a very young company in many of these markets, and we are growing in multiple businesses and currencies around the world,” says Robin Clark, executive managing director of BGC in London. “Thus, we are proud to have been able to supply our clients with a decent amount of liquidity within some difficult markets.”

Meanwhile, Sunrise dramatically improved on its result of last year with 19 wins in the equity derivatives categories, up from nine in 2007. Claude Amar, partner at Sunrise in London, says increased volatility and a spike in correlation across all asset classes prompted dealers to hedge more frequently, helping trading volumes. “It has been an extremely challenging year in all asset classes, with one of the largest market swings seen across all key drivers and catalysts of the financial markets. Multi-asset correlation might also have been the most volatile of the decade,” he notes. “In the few years preceding the subprime crisis and credit crunch, some assets used to have extremely low intra-day volatility, hence traders did not need to hedge part of their risks on a daily basis. The recent move in interest rates and currencies, for instance, has dramatically altered hedging strategies.”

The market conditions of the past 12 months have created challenges for dealers and brokers alike. But for those brokers with e-trading platforms already in place, and those that have diversified their products offerings through mergers or organic growth, the picture looks slightly rosier. “Overall, the dark cloud that covers the market could in fact be a real opportunity for some market participants,” says Lynn of BGC. ■

FIRST POSITIONS – INTEREST RATES

Brokers	Short-dated swaps	Swaps 2–10 years	Swaps 10+ years	Caps/floors	Swaptions	Exotic interest rate products	Inflation	Overnight index swaps	Repurchase agreements	Forward rate agreements	Total
Icap	3	3	4	3	3	4		2	3	3	28
Tullett Prebon				1			3	3	3	2	12
GFI						7					7
Tradition	1	1	1	1	2	1					7
BGC							3				3
Gottex	1	1	1		1						4

FIRST POSITIONS – CURRENCIES

Brokers	Cross-currency swaps	Vanilla currency options	Exotic currency options	Currency forwards	Total
Tradition-Icap		5	3		8
Tullett Prebon	2	1	1	3	7
Tradition	2			1	3
Icap	1			2	3
BGC			1		1
GFI	1				1

FIRST POSITIONS – EQUITY DERIVATIVES

Brokers	OTC single-stock options	Equity index options	Exotic equity products	Total
Sunrise	9	8	8	19
TFS			2	2
GFI		1		1

FIRST POSITIONS – CREDIT DERIVATIVES

Brokers	Credit default swaps	Structured credit	Total
GFI	8	7	15
Creditex		1	1