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Why Wall Street Needs Co-opetition

May 14, 2017

While market sizes are often measured in the trillions of dollars, the number of firms that are responsible for the majority of transactions is measured in the hundreds if not the teens. Examples of this are numerous. According to Greenwich Associates research, the top five dealer banks handle between half and two-thirds of investor trading in several markets including interest rate swaps, U.S. government bonds, corporate bonds and foreign exchange. The buy side has also consolidated, with 1% of asset managers now managing nearly 20% of the world's invested wealth.

The FinTech landscape is similar. Three electronic trading platforms – Bloomberg, MarketAxess and Tradeweb - handle over 90% of electronically traded corporate bonds globally, three swap execution facilities handled the majority of interest rate swaps trading by investors in the U.S. in April – Bloomberg, Tradeweb and trueEX - and even the U.S. equity market - infamous for its dozens of trading venues - sees three exchanges (BATS, Nasdaq and NYSE) handling over half of daily trading volume. And on a related note, the majority of data from those and other venues are delivered to users of that data by two providers.

It is debatable whether or not this is all good or bad, but it is simply a fact. When trying to buy or sell anything, the more participants you can gather in the smallest number of marketplaces the more efficiently you can match opposing interest. Just like social media, the platforms aren't effective unless everyone is on them. And for banks and investors, economies of scale are necessary due to regulatory complexity and beneficial to clients who often see better service offered at a lower cost.

Competition Must Exist

However, even if competition is concentrated, competition must exist. Even the largest market participants who receive the best service from providers of all stripes work to ensure that competition is alive and well in every facet of the business, bringing with it choice and innovation. This can come in the form of two or three offerings, where each has its' own focus and expertise, or via a long tail of smaller providers that are fast and nimble and keep the big guys on their toes. We've discussed this in previous research, pointing out the importance of startups to financial markets even though statistically speaking most of them will fail.

An interesting side effect of this environment is the strong presence of co-opetition in financial services - firms that compete in some businesses, but work together via partnerships or provider/consumer relationships in others. This might be a large investment bank looking to a large commercial bank for financing, or two technology companies providing each other data or services that ultimately benefits both sides. For instance, ICE licenses Markit's CDX and iTraxx indices. Yet ICE has a competing index business. Both firms also provide fixed-income security valuation services. In an industry where the major players are in control of a large percentage of the action, especially when essential services are involved, co-opetition is inevitable if not required to ensure the clients are ultimately well served.

Co-opetition Is Required

That argument could be taken one step further, stating that co-opetition is in fact required in concentrated industries because, without it, monopolies would surely occur. And monopolies aren't good for anyone (well, except for the firm with the monopoly of course). A recent case in point is the argument at the center of trueEX Group's recent lawsuit with Markit. trueEx needs to process trades via Markit to stay in business, but claim their launch of a competing service has driven Markit to cancel their access to those services. It, therefore, appears the U.S. justice system will give us the official word on whether co-opetition in the market is required to fend off monopolies.

A “may the best man win” approach has brought our financial markets to what they are today. The high levels of greed and low levels of morals of a small few individuals have certainly hurt the rest, but by and large, offerings that meet client demands within the guidelines set forth by regulators, legislators and the industry itself have ultimately changed the market for the better.

We shouldn’t, however, expect every small startup to disrupt the large incumbents. Economies of scale, relationships and a “no one was ever fired for buying IBM” mentality will continue to make it harder for newcomers to become the next incumbent. The fact is that running a profitable business on Wall Street, whether an investment manager, swaps dealer or FinTech, isn’t easy. As such, we’re left with only a relatively small few who can make it all work. As I said earlier, concentration isn’t necessarily good or bad – it just is. But if the concentration is all with only one firm, the industry should reassess its options.

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