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2012 Greenwich Leaders: Global Fixed Income

Risk of Fixed-Income Liquidity Shortages Remains High

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A downturn in global fixed-income markets brought on by an uptick in interest rates or other causes could trigger liquidity shortages for institutional investors.

As 2013 gets underway, fixed-income markets are functioning quite smoothly, despite fears that new capital requirements on banks would sap liquidity from institutional trading. Institutions should not be lulled into a false sense of security, however. The risks of a mild or even severe liquidity event remain elevated due to attrition in the inventories of the world's largest fixed-income dealers and the elimination of bank proprietary trading desks.

In the ongoing global bond rally, liquidity is not hard to find. But a look at the underlying market structure reveals a potentially dangerous fissure. Virtually all major banks have slashed their fixed-income inventories and shuttered proprietary trading desks that prior to the crisis represented an important source of supplemental market liquidity. To generate liquidity for their clients, dealers are increasingly relying on trade crossing among institutional clients, often carried out on electronic platforms. This process works well as long as buyers are in abundance. "But what happens when interest rates begin to rise and fixed-income markets begin to sell off?" asks Greenwich Associates consultant Andrew Awad. "When everyone wants to sell, there will be no one on the other side to cross trades with and capital-constrained banks will have no interest in assuming their traditional role of liquidity backstops."

Fixed-Income Dealers: A Global Sorting Out Process

Fixed-income markets continued their global sorting process in 2012 as major dealers adjusted their business models for the post-crisis regulatory environment. The exit of some global banks from key fixed-income business lines in the face of strict new capital requirements and retrenchment among many others put market share in fixed-income trading up for grabs last year. The end result: A continued loss of aggregate market share for the world's biggest fixed-income dealers, with some firms picking up volume, others losing it and freed-up trading business being broadly disseminated among top 10 and even top 20 dealers.

Deutsche Bank leads the global fixed-income market with a 10.7% share of overall trading volume. Barclays is second

Greenwich Leaders

The tables below provide the complete list of the 2012 Greenwich Leaders in Overall Global Fixed Income. Every year, Greenwich Associates names leaders in both market share and quality in Asia (ex-Japan), Canada, Europe, Japan, and the United States. Greenwich Share Leaders are awarded on an overall basis and in the major fixed-income product categories. Greenwich Quality Leaders are firms that have distinguished themselves by receiving quality ratings from institutional clients that exceed those awarded to competitors by a statistically significant margin. The Greenwich Leaders in Overall Global Fixed Income are based on an analysis of aggregated research results from all fixed-income markets covered in Greenwich Associates annual research programs.

Greenwich Share and Quality Leaders — 2012

Overall Global Fixed-Income Market Share

Dealer	Market Share	Rank
Deutsche Bank	10.7%	1
Barclays	9.8%	2
J.P. Morgan	8.8%	3
Citi	8.1%	4T
Goldman Sachs	8.0%	4T

Overall Global Fixed-Income Service Quality

Dealer
Barclays

Note: Based on interviews with 4,113 institutions. Share leaders are based on top 5 dealers including ties.
Source: 2012 Fixed-Income Investors Studies for North America, Asia and Europe

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with a market share of 9.8%, followed by J.P. Morgan at 8.8%. The combined 29.3% market share of these firms for 2011-2012 represents the second consecutive year of decline for the aggregate share captured by these market leaders. In 2009-2010 these firms together captured 32.9% of global fixed-income trading volume. Last year that share dipped to 31.4%.

This decline does not point to any permanent loss of influence on the part of these dealers. Rather, the recent erosion of aggregate market share among the world's top-tier dealers is a function of the ongoing strategic realignment among these important players. Virtually all major dealers responded to the imposition of new capital rules by reducing overall capital commitments to fixed-income and redirecting capital that is deployed to their biggest and best customers. As part of that process, many banks ceded trading business from institutions outside of their targeted clients.

But that loss of market share could well prove temporary, since all banks competing in these markets are coping with the same pressures. At the most extreme end of the curve, banks like UBS are essentially exiting some fixed-income business lines. "We still do not know what the business models of fixed-income dealers will ultimately look like, because they are still evolving," says Greenwich Associates consultant Frank Feenstra. "Individual dealers will pull out of certain products or sub-products in order to focus their efforts and their capital on businesses or regions in which they feel they have some competitive advantage."

Top Dealers to Benefit from Scale

In the end, this process could result in a market in which leading dealers actually increase their dominance and their aggregate market share in the trading of many fixed-income products. The reason: In highly liquid fixed-income products, or flow products, the ultimate competitive advantage in the new market structure might well be scale. With dealer inventories much reduced from pre-crisis levels, dealers must find new methods for supplying liquidity. They are doing this in two main ways:

1. By aggregating trading activity with the help of electronic platforms and using knowledge about institutional supply and demand to cross trades, and

2. By making more efficient use of their own fixed-income holdings by using inventory management systems that enable them to turn inventory over much more rapidly.

Scale is a critical component of both processes. Large amounts of trading volume provide dealers with insights into the location of supply and demand, thereby creating opportunities for trade crossing. Heavy trading volumes are necessary to generate acceptable levels of return on the sizable investments required to build and maintain the technology infrastructure for electronic trading, aggressive inventory management and collateral management in derivatives trading.

For these reasons it is quite likely that in highly liquid rates and credit products the big will get bigger as top-tier dealers leverage the benefits of scale to win even bigger shares of the market. Meanwhile, both top-tier dealers and other banks will focus on high-margin structured products in which relatively small units can earn substantial profits.

"Such barbell strategies, balancing huge flow operations against tightly focused structured products businesses, are being eyed by most of the major dealers as approaches that efficiently employ newly expensive capital," says Greenwich Associates consultant Tim Sangston.

Greenwich Associates consultant Woody Canaday concludes, "As the large global dealers gravitate to these barbell strategies, it could open up new opportunities for smaller dealers and regional players to stake out profitable businesses in the products in the areas between these two extremes."

Consultants Andrew Awad, James Borger, Woody Canaday, Peter D'Amario, Frank Feenstra, John Feng, Brian Jones, Peter Kane, Tim Sangston, Abhi Shroff, Taeko Sumiyoshi, and Tomio Sumiyoshi advise on the institutional fixed-income markets.

Methodology

Interview topics included service provider assessments, trading practices, market trend analysis, and investor compensation.

Asia (ex-Japan)

Between April and July 2012, Greenwich Associates conducted 1,011 interviews with fixed-income investment professionals at domestic and foreign banks, private banks, investment managers, insurance companies, hedge funds, corporations, central banks, and other institutions throughout Asia (ex-Japan).Countries and regions where interviews were conducted include Australia/ New Zealand, China/Hong Kong/Macau, India, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Sri Lanka, Taiwan, and Thailand.

Canada

Between February and March 2012, Greenwich Associates conducted in-person interviews with 114 institutional fixed-income investors in Canada.

Europe

Between May and July 2012, Greenwich Associates conducted 1,241 interviews with senior fixed-income investment professionals at banks, fund managers/advisors, insurance companies, corporations, central banks, hedge funds and other institutions

throughout Europe and the Middle East. Countries where interviews were conducted include Austria, Belgium, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Israel, Italy, Jordan, Latvia, Lithuania, Luxembourg, Malta, Monaco, the Netherlands, Norway, Oman, Poland, Portugal, Qatar, Romania, the Russian Federation, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Tunisia, Turkey, the United Arab Emirates, and the United Kingdom.

Japan

Between May and July 2012, Greenwich Associates conducted 336 interviews with senior investment professionals in Japan investing in domestic fixed income and 138 interviews with senior investment professionals in Japan investing in international fixed income. Interviews were conducted with banks (regional banks, shinkin banks, agricultural banks, trust banks, and others), investment companies and insurance companies.

United States

Between February and April 2012, Greenwich Associates conducted 1,085 interviews with institutional investors active in fixed income in the United States.

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GREENWICH REPORT

6 High Ridge Park Stamford CT 06905 USA

Tel: +1 203.625.5038/+1 800.704.1027 Fax: +1 203.625.5126 email: ContactUs@greenwich.com www.greenwich.com