

Risk

Citadel shaking up swaps competition

The Chicago firm has become a top-four market-maker on Sefs - but rivals question whether its prices are sustainable

Swap dealers have a fight on their hands. In the four months since Citadel Securities switched on its pricing algorithms full time, the Chicago firm's market-making arm claims to be beating the incumbent banks on price and on speed. The question – for potential clients as well as rivals – is whether it can keep that up.

“They’re quoting razor-thin spreads. There’s no way they can make money at those levels,” says a senior e-trading executive at one European bank.

Paul Hamill, global head of fixed income, currencies and commodities for execution services at Citadel Securities, says it can: “Are we loss-leading? Not at all – our cost structure and model ensure we can operate a profitable business with prices at these levels. Feedback from clients is that those happen to be tighter than everyone else, but that reflects our different cost base relative to other liquidity providers and the automated approach to delivering our model.”

Hamill says the firm is generally quoting between 0.2 to 0.25 of a basis point for a 10-year US dollar interest rate swap in notional sizes of up to \$60 million – the typical social size for on-screen trades – but prices can be as tight as 0.1 or as wide as 0.3 for larger sizes. The full bid/offer spread for the average bank is typically closer to 0.4 or 0.5 for comparable trades, he claims. Three rival dealers broadly corroborate those claims.

As a result, Citadel ranks fourth by volume on Bloomberg this year – currently the market's biggest swap execution facility (Sef) – and Hamill says it wins a greater proportion of trades on which it is asked to quote than any other dealer.

The firm's arrival as a provider of swap liquidity to clients is only possible because Sefs are required by law to be open to all participants, and all Sef-executed trades have to be cleared – removing the requirement to accept years of counterparty credit risk with each new trade. It sets up a clash of business model – between Citadel, which is basing its pitch solely on the classic market-making virtues of reliability, tight prices and speed – and traditional dealers, which



Paul Hamill, Citadel Securities

have broader relationships with clients.

After launching its business on Bloomberg and Tradeweb on October 27 last year, the firm is now a member of six Sefs. It currently quotes a variety of US dollar products – outright, curves and butterflies – but plans to add more products and expand to euro and sterling later this year.

Some banks dismiss the threat. “Citadel has not impacted us in the least. When we service customers, it’s a more holistic approach – a full-service proposition with research and market colour. It is a much broader service than liquidity online,” says one dealer’s e-trading head.

A senior fixed-income source at a third bank claims his employer could quote closer to Citadel’s spreads and still make money, but says it doesn’t need to. “At three-tenths, we would at least break even. We do business at our spreads because we have clients that want to do business with us. If Citadel’s client business is successful, then they’ll have clients that want to do business with them there,” he says.

Some customers are paying attention: “I’ve heard about the prices they’re quoting. I haven’t used them yet – I haven’t had to request a quote this year – but I’m certainly open to it. Having a new party come in is fantastic,” says Michael

O’Brien, global head of trading at Eaton Vance in Boston.

In all, Hamill says the firm has received quote requests – the dominant mode of Sef trading between dealers and clients – from 90 firms, while the established players might be receiving enquiries from 300 or more accounts. He says Citadel can go further: “We have a lot of work to do as we reach more clients, but for four months in, we’re very pleased with the results, the volumes and the lessons we’re learning.”

Faster response

Price is not the only draw, he argues. A breakdown of average response times for dealers on Bloomberg – part of an as-yet-unreleased Citadel marketing brochure – shows the firm getting back to client enquiries in 0.35 seconds. Its closest rival has an average time of 2.05 seconds. Many others are responding in anything from five to 11 seconds.

Hamill says this reveals another difference: many other dealers quote indicative prices to Sefs, rather than firm ones, meaning a client’s quote request will often see the original price nudged wider by a trader.

He credits colleague Yanfeng Chen – an April 2014 hire from Credit Suisse – for Citadel’s pricing. “He was here for many, many months before me building and calibrating the risk and hedging models and getting the operational and connectivity aspects set up right. He is very well respected as a practitioner, with a deep understanding of how the market works and has traded it for many years. We have similarly experienced quants and IT resource around that,” says Hamill.

So, can those models stay the distance when things get rocky? Eaton Vance’s O’Brien, for one, thinks so: “I hope it’s sustainable. Across a lot of different asset classes, we’ve seen people come in, make a big splash with really tight prices that were unsustainable and eventually fade away over time. Based on the people I know at Citadel, I don’t think they’re going to do that.”

Duncan Wood