

# Citadel adds custom swaps in rapid expansion

## › Liquidity supply gap identified in fixed income

Citadel Securities has expanded its ambitions beyond benchmark vanilla interest rate swaps with a push into customised derivatives as the new entrant encroaches further onto the turf of big swaps dealers that have dominated the market for decades.

After rising to a top three position for electronically-traded US dollar benchmark swaps within a year of the platform's 2014 launch, the securities arm of the Chicago-based hedge fund has started making markets in US dollar swaps whose dates stray from typical benchmark contracts – a structure that is commonly used by insurance companies and Federal home loan banks to more accurately hedge their liabilities.

“We identified that there was a liquidity supply gap in fixed income starting with benchmark swaps and have been growing and diversifying the business globally and across products in response to investor demand,” said Paul Hamill, global head of fixed income, currencies and commodities at Citadel Securities. “We have also started providing liquidity beyond just the benchmark products, including forwards, forward starts, packages and custom dates.”

Just 18 months since launching its swaps market-making business, Citadel frequently ranks as the number one player by volume on the Bloomberg swap execution facility, cementing its top position across a range of metrics including client enquiry, response times, and quote size.

“We’re among the top few market-makers in interest rate swaps and continue to grow that business by diversifying our

client base and product offering,” said Hamill. “Custom swaps trade less than standard contracts but it is still a product that is important to investors and there’s an opportunity for us to deliver innovation and better pricing to our clients.”

Forward starting contracts and customised swaps form part of the 50% of the US swap market that does not yet trade over SEFs, according to data from Clarus Financial. As such, transparency is lower than in the SEF-traded benchmark market and a bigger portion of activity continues to rely on voice execution.

As part of the plan to expand its platform and in a departure from its initial electronic focus, Citadel added voice execution in March. That development supported expansion in Europe, where only 30% of interest rate swaps trades have made the shift to electronic platforms, while also opening the door for customised products that trade with lower price transparency and typically require more negotiation.

A typical dealer set-up would see clients contact a sales person, who must then ask a trader to make prices. Citadel has streamlined the operation by rolling those two functions into a single layer, with electronic prices feeding directly to the three voice traders now working on the US platform.

With limited price transparency compared with the SEF-traded market, competitive comparisons for customised swaps across the dealer community are more complex. However, with most customised activity only sitting a few days’ outside the benchmark dates, Citadel believes that its pricing is competitive.

### Swaps overhaul

Citadel’s expansion came in the wake of reforms to the US\$493trn OTC derivatives market that force up to 70% of the swaps market into central counterparty clearing, with the most standardised products traded on exchange-like platforms.

The changes, which are well under way in the US and at the start of implementation in Europe, have coincided with stringent capital and leverage requirements placed on banks as part of Basel III, sapping profitability across fixed income trading businesses.

Many predicted a surge of new entrants, but others such as KCG Partners and Virtu Financial, which have been touted as potential players, have been slow to follow Citadel’s lead.

“Many people expect disruption of the status quo to come from non-banks. Other than Citadel Securities there are not many non-banks that have the resources to create a new entrant swaps business; however we expect that to change,” said Hamill.

Dealers including UBS and Morgan Stanley have launched more capital-efficient agency-style platforms in an attempt to address rising costs associated with swaps market-making, while some mid-tier banks have also responded to the liquidity gap with a concerted push into swaps trading.

Natixis has expanded its activities in the US swap market, while Mizuho International became a member of LCH’s SwapClear earlier this year as part of an effort to expand its multi-currency swaps business in Europe.

Last year, Mizuho hired Campbell Gilbert as head of European flow derivatives to lead the development of the rates trading desk.

Helen Bartholomew