trading · treasury · technology

fx-mm

December 2016 / January 2017

Fintech stars 2017

The future of prime broking

Currency outlook

Total control

Saxo Bank's Peter Plester on the technology allowing prime of prime brokers to fill the FX credit gap

fx-mm.com

Primed *for the* future

Peter Plester, Head of FX Prime Brokerage at Saxo Bank, explains to FX-MM editor Peter Garnham how technology is enabling prime of prime brokers to fill the credit gap in the FX market.

The rise of prime of prime (PoP) brokers in FX has its roots both in the retrenchment of the traditional prime brokers and the ability of smaller, more agile firms to harness the latest trading technology, according to Plester.

His expertise in the field is born from a career that took him from the arbitrage desks of some of the world's leading FX banks to setting up a successful prime broking business at AAA-rated Rabobank, before taking the helm at Saxo just over two and a half years ago.

Plester's move to Saxo would appear to be significant, coinciding with a shift in the provision of prime broking services as larger traditional providers withdrew from the market.

"There was a realisation that prime broking in FX had become very big and the increasing prevalence of low-latency, high-frequency trading meant that providers needed to have more control," he says.

That meant that institutions either had to add the pre-trade risk controls that could enable them to accept smaller, less well capitalised clients that posed a bigger risk, or just keep the bigger, well capitalised clients whose risk was covered by their balance sheet, according to Plester.

"A lot of the big prime brokers, rather than having to change and rebuild their trading systems, decided to get rid of their smaller clients and keep the large well-capitalised ones," he says. "Therefore, all those clients that had been off-boarded by the bigger bank prime brokers needed a new home. There was a right-sizing exercise by the bigger bank prime brokers and so a lot of those clients moved their accounts to Saxo

Indeed, volumes at Saxo's PoP business have increased by 500% over the last two and a half years, according to Plester.

Technological control

The reason why Saxo is happy to provide prime broking services to those small and medium-sized clients is that it uses the latest technology in terms of margining, pre-trade risk control and dynamic limit allocation, Plester explains.

"We can better control how our customers connect to and trade with the market," he says. "We are happy that we are able to control our clients' access to the market in our name using the latest technology."

In the past, risk management systems for FX prime brokers did not connect to all venues in the market.

"You could cover your risk on certain venues but not all of them, and so it was a bit like having a bucket with a hole in it," says Plester. "It does the job, but it doesn't do the job as well as you would like."

Modern credit control structures effectively mean that prime brokers can create a gate between a client and the entire market, meaning they can shut that gate if, for example, it loses too much money.

"We are one of the few PoP brokers that by default don't put our own prices in that stream because we don't want to be conflicted with our clients"

That necessitates that clients route all their trading through a risk layer, which Plester concedes does add a tiny bit of latency – perhaps a few millionths of a second – to their trading activity.

"I think a few microseconds of latency is definitely a price worth paying by the client to make sure their trading is properly managed," he says. "It also provides assurance for the prime broker, because if you have people trading in your name then you want to make sure they are doing it responsibly."

Aligned with the client

As a PoP broker, Saxo does not use its own credit to access liquidity from the FX market; it uses its two prime brokers, Deutsche Bank and Citibank. Indeed, as Plester explains, Saxo has two distinct FX products for API clients.

"We have the prime brokerage direct market access offering, which is on one infrastructure, and then we have our own direct offering where our clients can connect and trade with Saxo's own pricing," he says. "That is on a separate infrastructure and we don't mix the two."

That is important since, as Plester observes, there are very few real providers of credit intermediation in the FX market. There are, obviously the big bank prime brokers such as Deutsche Bank, Citi, JP Morgan and UBS and a host of PoP brokers that sit under those institutions.

"Some of those are proper PoP brokers that do offer clean direct market access to their clients, but there are also some so-called PoP brokers that offer their clients a price feed, which they claim to be from a certain number of bank and non-bank liquidity providers, but which also include their own pricing."

That, says Plester, creates an opaque price stream for clients, and raises the possibility that their own broker is effectively betting against their flow, so-called B booking.

"We are one of the few PoP brokers that by default don't put our own prices in that stream because we don't want to be conflicted with our clients," he says. "Our interests are aligned with our clients rather than against them."

In addition, Plester adds, Saxo's status as a well-capitalised, properly run financial institution, with around $600 million of its own capital, and around $13 billion of client funds under management, gives it an edge in the PoP space.

"We have a decent balance sheet, and being a bank, the regulatory obligations we have in terms of capital adequacy are higher than for other non-bank PoP brokers," he says. "Clients get a lot of comfort knowing their PoP broker has a huge amount of its own money standing between them and the market."

Proper market making

The electronic nature of Saxo's offering allows for the aggregation of a lot more price feeds than in the past, including those from more than twenty bank and non-bank liquidity providers.

"A lot of the flow we send out does go to non-bank liquidity providers, but you have to be careful because not all non-bank liquidity providers are the same," says Plester.

He says Saxo only uses non-bank liquidity providers that take risk like banks: those that quote prices they have created rather than simply aggregating other firms' prices.

"The non-bank liquidity providers we use are very much proper market makers," adds Plester. "They are ones that warehouse risk."

Technology also enables Saxo to offer clients a liquidity optimisation service. The bank's systems monitor fill rates and response times from all its liquidity providers, allowing it to offer reports to clients on their trading performance.

"Clients can see how the liquidity providers with which they are trading are performing, enabling them to make decisions on whether to remove some liquidity providers or whether to initiate discussions with liquidity providers in order to change the price streams they are receiving," says Plester.

Saxo aggregates prices from bank and non-bank liquidity providers in data centres in London, New York and Tokyo, so that clients can access local liquidity.

"We wouldn't take a price from a market maker in London and feed that over to Tokyo because it would be too slow. That would affect the quality of the price stream: the response time would be very slow and the fill rates would be terrible," says Plester. "To make sure that all clients get the best possible price, the best possible trading conditions, we make sure that the prices they receive are created locally in those three hubs."

Added value

Saxo's PoP offering has, according to Plester, been a great help to small- and medium-sized hedge funds that have lost the services of the large bank FX prime brokers. It is not just that sector that has benefitted, however, with many money managers, family offices and funds as clients.

"It is not just the access to price that attracts clients, we have a lot of other value-added services to offer," he says.

Plester cites Saxo's ability to offer managed accounts, and real-time back office end-of-day reporting as just some of those services. Indeed, Saxo offers over 100 different types of end-of-day reports and offers a real-time API for trade data and account data.

"A client can plug the API into their own system and access a feed that shows all of their trades, account values and commissions as they happen in real time," he says. "Another attraction is that Saxo is a truly multi-asset institution. Clients can not only trade spot FX through us, but there are about 30,000 other assets they can trade."

Interestingly, another significant client type that Saxo services is other retail brokers.

"It is a testament that we are the credit provider, prime broker as it were, for some of our biggest competitors," says Plester. "They are quite happy to use us because our prime broking activities are run on an entirely separate infrastructure from our trading activities."

> *When there are large movements like the SNB event and the sterling flash crash, when the market moves a great deal in a very short space of time, it is a good idea to have control over what your clients are doing*

Ultimately, according to Plester, it is technology, particularly around pre-trade risk, that enables Saxo to offer its PoP services to such a diverse client base.

"It is about making sure you use the latest technology to give your clients the best possible product. It is expensive and is a lot of work, requiring an awful lot of system integration and maintenance," he says. "But if you can get it right, it does make for a really good product."

Ahead of the curve

For Plester, the big changes required to major prime broking banks' technology infrastructure in order to implement pre-trade risk controls in FX have been an impediment to the industry. He believes, however, that now the technology exists to apply the sort of pre-trade risk controls seen in equity trading to FX, regulators will push for them to apply in the currency market.

As Plester points out, there have already been soundings from certain regulatory bodies around the world that they would like to see a safer currency market. Those calls are only likely to be amplified by any repeat of the market dislocations caused by the Swiss National Bank's (SNB) removal of the floor in EURCHF last year or the sterling flash crash this autumn.

Indeed, Plester believes that Saxo's adoption of pre-trade risk technology puts it ahead of the curve.

"Now that the technology is available, regulators will be saying prime brokers should be looking at these products," he says. "After all, when there are large movements like the SNB event and the sterling flash crash, when the market moves a great deal in a very short space of time, it is a good idea to have control over what your clients are doing to protect yourself and your clients from losing too much money."

For further information: **www.markets.saxo**