The future of prime broking

FX-MM brings together leading industry experts to examine the state of play in prime brokerage. As larger banks raised their requirements and pulled limits in the wake of the financial crisis, a new breed of agile prime of prime brokers picked up the slack, often improving market access for smaller hedge fund and FX trading operations. We consider how these offerings have developed and what the potential effects have been on the wider market.

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Peter Garnham: What has been the driving force behind the withdrawal of prime broking services by the traditional providers? Do you think the trend will continue?

Louisa Kwok: There are two key drivers here – return on equity and adverse market events.

The increased cost of being in this space has heightened the focus on return on equity. With growing regulatory requirements around aspects like capital, margin and reporting, we've seen many FX desks and prime brokers review the cost of operating in this space and adjust their own strategy. In some instances that has been to exit all together, or scale down to only accommodate strategic clients.

In addition, the market events of the last few years have left many prime brokerage clients in precarious positions. The most obvious here is the Swiss National Bank move but repercussions were also felt around events like October's sterling flash crash, Brexit and the US Presidential election. Again, this has impacted how prime brokers view their business and on the basis that some have taken direct hits from these events, they are keen to ensure risks are clearly accounted for and there is appropriate return.

What we also see is not a complete exit of this space by the banks. As with many volatile events, you have winners and losers. Those that could not withstand the systemic shock or increasing requirements to evolve in this space have fallen to the wayside, while those that are left are the stronger performers. We expect change to continue with prime brokerage becoming more expensive – particularly beyond spot. However, we would not rule out emergence of new providers that see an opportunity in filling the void left by others, particularly for longer dated derivatives.

Jonathan Brewer: There is a general trend amongst the banks that they are paying more attention to the return that they get on risk and balance sheet utilisation. This has led to a re-evaluation of the viability of offering FXPB services to some client groups.

The retail FX broker market in particular, has been one of the client groups that many of the traditional providers have concluded to be not viable. The main reason for this is risk related; it is structurally very difficult within a traditional PB to risk manage clients at point of execution, which means that traditional PBs have to look to the balance sheet of a client as their ultimate recourse in the event of a default. The result of this is that many clients, particularly retail brokers, have not proven to be viable counterparties from the banks' perspectives.

Whilst banking is inherently cyclical, it is very likely that this trend will continue, and this is more likely to be a structural shift rather than a cyclical adjustment.

Gavin White: Bank-centric regulatory reform is undoubtedly the main catalyst driving the transformation of the industry. Since the Basel III reforms began being implemented in 2014, the global banks have been steadily subjected to higher hurdles, tighter restrictions and tougher rules.

Most importantly, the capital requirements the banks face related to their prime services activities have been dramatically affected. The Basel III implementation timeline runs out in 2019, but before then the Basel IV rules will begin phasing in – and they are expected to be even more restrictive.

But what is happening is more than just the retreat of the banks from prime services. The real story is more complex than that. It is a fair summation to say that, overall, the banks have been withdrawing from prime services, but of course, each bank has responded differently according to the profile of the client base, their own cost base and capital situation, and the various activities that they are comparatively better at.

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So, some banks have undertaken a large-scale off-boarding of clients they have deemed too low-value in the post-reform environment. Other banks have simply hiked fees for prime services and pared back their offering to the more vanilla products and services. Others still have increased margins requirements and have begun charging for services which previously didn't incur fees. Some banks have done all of the above.

We have seen this sort of ebb and flow from the traditional prime services providers in the past. But this time is different, because this time it is not the result of the banks deciding internally to withdraw from providing certain services, or hike fees, because of business-related, internal reasons. This time, the banks are being forced to make changes due to the external influence of regulatory reform. These regulatory reforms have been a long time in the planning – and a long time being incrementally implemented. They are going to be in place for decades to come. In that regard, we believe this is a generational transformation in the prime services industry.

Peter Plester: I think there was basically a realisation after a while that prime broking had become very big, and with very low latency, high frequency trading increasingly predominant, banks really needed to have more control over their operations.

So either they had to add pre-trade risk controls so that they could accept smaller clients because they pose a bigger risk as they are not so well capitalised, or they could just keep the big clients, the really well capitalised big clients because the risk is covered by their balance sheet.

A lot of the big banks, rather than having to change all their systems and rebuild everything, decided to get rid of the smaller clients and keep the big well-capitalised ones.

Gavin White: As mentioned, the real story is more complex than just the retreat of the banks. This retreat is not uniform across the banks – and some banks are beginning to specialise in certain products and services rather than simply retreating. It has become a very interesting industry suddenly – and for those clients who can afford it, maintaining more than one prime broker relationship has become essential.

Below the traditional PBs, the transformation has been just as dramatic. The changes at the banks have given opportunity for new non-bank prime services entities to prosper. Less than five years ago, a client who was unable to maintain a bank FXPB relationship had no other real alternative than to revert right back down the food chain and get credit and liquidity from a retail broker. Nowadays there is much more choice. Specialist non-bank prime services providers have evolved. Some, like my firm Invast Global, are multi-asset prime services providers who pride themselves on their cutting edge technology, transparency and flexible, customised solutions.

Over the past few years, this segment of non-bank prime services providers has evolved and matured. There are now discernible "tiers" of non-bank providers. As a listed, highly-capitalised entity, Invast Global sits at the uppermost end of the segment, but there are numerous other alternatives for clients, stretching all the way back down to the retail brokers.

It is our view that the non-bank prime services segment will continue to stratify further over time. The beauty of this is that clients will be spoiled for choice and will be able to source a prime services broker that best fits their business needs, in terms of price and product offering.

But I think one of the best outcomes of the growth of non-bank prime services is that many clients will now be able to support more than one prime services provider. This has universal benefits related to the decentralisation of risks throughout the industry. It's exactly the outcome the regulators would be hoping for.

Peter Garnham: How has market volatility, particularly in FX, affected the way in which prime brokers offer their services?

Peter Plester: When the market moves in a crazy way, if you have people trading in your name, you do really need to be able to control them. It is a bit like having someone with a credit card in your name. You want to be able to stop people spending your money if they are no longer approved to do so.

Because we use the latest pre-trade risk control technology, we can do that.

Jonathan Brewer: Heightened volatility increases the risk of a client default for a PB. The only protection that a traditional PB has is the initial margin that they hold, and the balance sheet of their counterparty. The tier one FXPBs have therefore increased initial margin and minimum capital requirements of their clients.

Louisa Kwok: Prime brokers have essentially hiked the barriers to entry, in terms of minimum asset requirements, diversification in the types of clients they want and steering away from clients that could be deemed as higher risk. We have also seen improved risk controls and bespoke margining. Yes, this cuts out some business, but the greater focus on the remaining client relationships is arguably beneficial for the broker.

Gavin White: The various liquidity crises we have seen over the past few years (SNB event, Brexit, US Election etc) have made FX a much riskier asset class. Bank-centric regulatory reforms are forcing banks to maintain higher capital and liquidity requirements analogous with the risk associated with each asset class.

Therefore, the increased volatility is inextricably linked to the withdrawal of the banks in both prime services and liquidity provision.

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Peter Garnham: How far can prime of prime brokers go towards filling the liquidity gap? How are they leveraging technology to improve the services they offer investors and maintain control of trading limits?

Jonathan Brewer: The key advantage that prime of primes have versus the tier one PBs is the ability that they have to risk manage clients at point of execution and in real-time. This enables us to facilitate business that the traditional players are no longer prepared to support.

The main benefit that a prime of prime offers to their clients is the benefit of scale. If you are transacting a large amount of volume, you are able to demand more competitive liquidity from your providers, which means that a PoP can offer more competitive pricing to a client than that which they would be able to get from the same liquidity providers directly.

In addition to the quantity of flow, it is a prime of prime's ability to manage the quality of the flow being transacted which is actually more important.

This is where technology comes into the equation; we have very detailed flow analytics which enable us to assess the quality of the flow that we are sending to our LPs and we have the ability to intelligently route flow that is less advantageous to liquidity sources that are more appropriate. This is a critical factor in managing liquidity, and our expertise and technology in this field enables us to ensure that we can offer the best liquidity available in the market.

Louisa Kwok: At the moment, there are so many variations of how prime of prime is defined, with everyone claiming to offer 'pure' or 'true' prime of prime.

In general, prime brokers today are looking to have fewer but deeper client relationships. Prime of prime supports this by providing services to the next tier of clients with flow ultimately going back to the tier one prime brokers. This does, however, mean that smaller or clients with riskier strategies are left without coverage. The risk controls at the prime of prime are key and technology plays a large part of this. Whilst prime brokerage has traditionally operated on a post-trade limit monitoring basis, prime of primes are adding an additional layer of pre-trade limit checks. In addition, the prime of prime should have sufficient technical know-how in prime brokerage, a strong risk model, and capital to prevent and sustain potential default of an end client. The questions asked of prime brokers previously should be applied to prime of primes.

Currently, there is still heavy dependency on the tier one PBs, which is why most view prime of primes as a partner or client. How this evolves will depend on advances in fintech to provide access and simplify the large uplift in getting others to completely fill the space left by banks. The banks themselves will also be looking to these solutions to upgrade and reduce their downstream costing.

Peter Plester: Technology, specifically pre-trade risk controls, is the way we get comfortable with and control client risk. Others that don't use that technology are allowing almost unfettered access to the market in their name.

Peter Garnham: What factors should investors consider when choosing a prime of prime broker?

Louisa Kwok: The following considerations need to be made: liquidity – what do you get to see, is it restricted and can you incorporate your own liquidity sources?

How strong is the prime of prime broker – which prime brokers do they work with and where does the risk lie? Is your prime of prime setup as a pure credit intermediator or are they taking risk on your positions? Do they have depth of experience when it comes to prime brokerage – can they address challenges ranging from trade flows to legal negotiations which is key in this constantly changing landscape?

Selecting and onboarding prime brokers is an investment and ideally, one that's not changed frequently.

Peter Plester: Many clients underestimate the complexities in managing liquidity. Less is often more when it comes to the number of liquidity sources that is optimal. There can often be a large difference between a visible quoted spread and the effective spread that can be measured post-execution.

Saxo has strong relationships with all the major providers of unique liquidity. We are able to leverage the strength of these relationships on the basis of our cumulative flow in order to achieve better liquidity quality for our clients, which is something more difficult for any single client to do on their own. We have decades of experience in tuning liquidity pools and this is an integral value-added service to our clients that a technology driven PB like Saxo can offer, and one that traditional prime brokers are not providing, possibly because those traditional credit intermediaries are also providing execution services to their clients.

Jonathan Brewer: Rather than a simple credit intermediary, we see our role as a specialist liquidity and execution facilitator. Electronic trading and optimisation is deeply entwined into the DNA of the ISAM Group, and we are able to leverage this expertise to manage flow and liquidity in an optimal way.

Many PoPs are simply white labels of expensive, inflexible third party technology solutions with little expertise in liquidity management; we would advise that clients should do their due diligence and choose a PoP that is able to really provide value added services rather than an "out of the box" solution.

Another key consideration that is often overlooked is whether the PoP provider is really incentivised to operate in the best interests of the client. There are many PoP providers who operate as, or are owned by large players in the retail market, and are therefore major competitors to their clients. Whilst it is good to look for a prime of prime that is part of a stronger, broader group, it is counter intuitive to trade with a provider that ultimately can't have your best interests at heart, and also to fund the marketing budget of a major competitor.

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Gavin White: The PoP must be well-capitalised with a strong balance sheet and established prime broker network to offer a stable service with a variety of options for client customisability.

It is very important that the prime of prime has at least one direct tier one bank PB relationship – preferably multiple relationships – underpinning their offering. This ensures stability of conditions for the PoPs clients. The stability of relationships with tier one FX prime brokers and liquidity providers will only become more important as regulations tighten and access to tier one PBs becomes tougher.

Just as importantly though, the PoP must offer its service in the same way the traditional PBs do – that is, they must be transparent through to the end liquidity provider. They must not internalise or warehouse flow. Their interests should be 100% aligned to those of their clients. Many brokerages hold themselves out as PoP, yet internalise flow and trade against their clients.

Also, in the same vein of transparency, the best PoPs are listed entities, with all of the transparency and reporting obligations associated with being listed.

Peter Garnham: Given that prime of prime brokers often leverage the credit of their own prime broker, to what extent are they really solving the liquidity gap, or are prepared for market dislocation such as that prompted by the SNB last year?

Jonathan Brewer: A client should not look at a PoP as a simple credit intermediary. If this is the only service that the PoP is providing, then I would advise the client that they can find a more advantageous solution elsewhere.

The liquidity gap is in fact a completely different subject, as it relates to provision of liquidity rather than credit. The liquidity gap issue has arisen as a result of the reduction in the ability of the major bank LPs to take on risk and therefore provide unique pricing.

There is a trend in the liquidity market towards more nimble, technology intensive non-bank liquidity providers who are filling the liquidity gap left as the traditional players pull back. We see this as a trend that is likely to continue, and as an opportunity for the more sophisticated players in the prime of prime space to take advantage of.

Gavin White: PoPs do leverage the credit of the own PB, but they are being extended that credit because they pass the stringent balance sheet requirements of that PB. So, only highly capitalised entities can sustain a PB (or multiple PBs). This funnelling of counterparty risks – from retail through to low end prime of prime, through top tier PoP, through to traditional PBs is effectively disseminating risk across the industry. As PoPs offer reduced fees and other requirements (such as, no monthly commission minimums), it allows many clients to have multiple prime services providers. This is another factor where the effect is a dissemination of risk. It's a far cry from the environment a few short years ago, where clients only had a choice between bank PBs at one end of the scale and retail FX brokers at the other end.

Louisa Kwok: There are two distinct questions here. The liquidity aspect depends on understanding exactly what your prime broker is offering. Are they extending their own balance sheet to counterparties in any meaningful way, or are they simply looking to carve up and administer what is already on offer from established PBs? If it's the latter then they're doing little to aid liquidity.

As for market dislocation, proper risk management is critical here so there needs to be some visibility across the entire chain, allowing each party to evaluate risk and creditworthiness. Critically, the prime of prime must be able to show that they have the credit worthiness and staying power in the FX space – and expertise in managing FXPB relationships.

For further information: www.fx-mm.com