FX, CFD reforms to transform industry: Saxo Capital Markets Australia

Ben Smoker thinks regulatory change in the retail foreign exchange and contract-for-difference industry will ultimately be good for clients and the industry.

“I think it will be transformative for the industry, particularly in the leveraged product space,” the chief executive of Saxo Capital Markets Australia told The Australian. “It will have a huge impact on some business models but it will be good for the industry.”

After surprisingly tough new regulations on leveraged products were announced by the European Securities and Markets Authority last month, Saxo has launched a market segmentation and
responsible leverage initiative here, which is also in anticipation of upcoming changes in the law regarding the design and distribution obligations and product intervention power for ASIC.

Draft legislation in Australia includes recommendations from the financial system inquiry to introduce design and distribution obligations for financial products to ensure they are “targeted at the right people”, and a temporary product intervention power for ASIC when there is a “risk of a significant consumer detriment”.

ASIC’s approach is principles-based rather than prescriptive as it is in Europe — where ESMA said it would ban binary options and slash the leverage available on CFDs according to the volatility of the underlying instruments. But Smoker expects similar effects on the leverage available to retail investors and the models used to distribute financial products here.

Some retail FX and CFD providers in Australia currently offer leverage of up to 200 to 1 on the major currency pairs, whereas in Europe that’s been capped at 30 to 1. And while many now offer direct market access, market-maker or “B market” models — where clients effectively bet against their broker, thereby incentivising them to offer more leverage — are still prevalent.

“There’s a whole thematic across all regulators post GFC to look at the appropriateness of financial products and how they’re being distributed — in other words they want to make sure we have the right sort of products going to the right sort of clients and that the client’s best interest is the priority for distributors, as opposed to profit or revenue,” Smoker says.

The leveraged product class was an area of particular focus because after the GFC and the Swiss Franc event — the abandonment of the euro-Swiss Franc peg — there were significant client losses, which drew regulatory scrutiny.

“ESMA did some analysis of client profitability, client life-cycle, client benefit,” Smoker says. “They found that offering high levels of leverage to these inexperienced traders wasn’t producing the greatest results for them in the long run.

“Giving a less-experienced retail investor leverage of 200 or 400 to 1 on financial instruments is a bit like tossing the keys to a turbocharged V8 to a provisional or learner driver — it’s exciting and adrenalin-packed, but it’s fraught with danger, and it’s probably not the most appropriate thing to be doing.”

So what is appropriate leverage for a retail or less-experienced investor?

Saxo Bank’s white paper on this subject looked at the difference in providing FX and CFD leverage of up to 200 to 1 versus scaling that right back down to 33 to 1 or 20 to 1.

“The results were amazing because we saw that potentially over 75 per cent of less-experienced retail investors would lose money using that kind of leverage,” Smoker says. “But if you drop the leverage to appropriate levels around 33 to 1 for FX or 20 to 1 for indexes, their propensity to make money goes up to better than 50 per cent.”

He argues that the effect of leverage is even more significant when tied with the way the products are issued.

“Whenever you take the other side of a trade (in a market-maker model) you make money when the client loses, so there’s an immediate conflict of interest, in my view. And we know that if you increase leverage, there’s a greater probability of the retail client losing, so the broker stands to win with greater frequency if they offer more leverage.
“There’s a misalignment or conflict of interest under the market maker model because it incentivises brokers to issue as much leverage to retail investors so there’s a great propensity for them to be stopped out, allowing the broker to win.”

The attraction of high leverage is that a client can invest a small amount of money to have a big position in the market, but if the position goes against them, their initial margin is chewed up and they need to outlay more money to support the position. If they don’t have more money, the broker will just close their position, crystallising a loss.”

Japan and the US clamped down on the retail FX and CFD industry some time ago, slashing the allowable leverage, and in the case of the US banning CFDs for retail altogether, but Smoker doesn’t expect that to happen in Australia. “You have regulators doing a deep dive into the industry to work out what’s appropriate and one thing they have established is that there’s a definite place for leveraged products because they give a low entry price for exposure to a broad amount of asset classes.”