© vita pakhai / Shutterstock.com

ROUNDTABLE

With contributions from:

Alan Schwarz
CEO, FXSpotStream

Alfred Schorno
Global Head of Sales 360T Group and member of 360T's Executive Board

David Vincent
Co-Founder and CEO, SmartTrade Technologies

Peter Garnham
Editor, FX-MM

FX-MM's FX roundtable brings together industry experts at a time when the market is undergoing profound change, with the rise of non-bank liquidity providers and the retrenchment of prime brokers, and the increasing importance of connectivity.

Peter Garnham: What has been the most significant shift in FX liquidity provision in recent times?

Alfred Schorno: In the early 2000s when electronic trading was evolving, banks chased the opportunity to take risk onto their books from as many clients as possible. This was a scale proposition with e-sales selling bank liquidity and the e-platform to clients who would typically not fully justify the costs of provision of the bank's full service sales offering. Scale that let banks expand and globalise their principal trading activity, to complete their electronic offering.

The situation now is quite different. We are seeing far more white labelled liquidity at banks, allowing the bank to offer particular currencies as matched principal in order to avoid the need to run trading desks that are not viable. We are also seeing more agency and facilitation offerings, so the bank retains the client relationship and gains a fee on the execution without the need to be principal to the trade.

All of this has created space for non-bank liquidity providers to step in, typically as a behind the scenes operation happy to provide

liquidity bilaterally or via ECNs which can be used to back up the bank's activity in client facilitation. However some non-bank liquidity providers are now starting to build direct relationships with end clients too, so the line between bank and non-bank liquidity provision is likely to increasingly blur.

Alan Schwarz: We certainly see some shift in terms of an increase in non-bank market makers, versus bank market makers. I do not believe banks will stop becoming market makers, however. I think that is a function they perform, have performed for a long time and have performed very well. They are there when the market needs support. But there is no doubt there has been an increase in non-banks performing a market making function in part because there has been a change in the regulatory landscape: an increase in capital constraints, capital requirements on banks, etc. All that has, in part, led to the increase in non-bank market makers.

What we might see is a reduction or concentration in the banks that will continue to make markets, and I think we will see some increase in the number of non-bank participants.

But the question then becomes, and I think it is still an open question: what is the difference between a bank market maker and a non-bank market maker, and what is the difference from the client's perspective. And do they in fact perform exactly the same function? My view is they don't.

The question you have to ask is: are the non-bank makers actually warehousing risk and behaving in the way that a bank will? Because that obviously has an impact on the price that somebody is quoting. Plus in times of stress in the market, will non-bank makers be there when you need liquidity?

> *There is no doubt there has been an increase in non-banks performing a market making function in part because there has been a change in the regulatory landscape: an increase in capital constraints, capital requirements on banks*
> *Alan Schwarz*

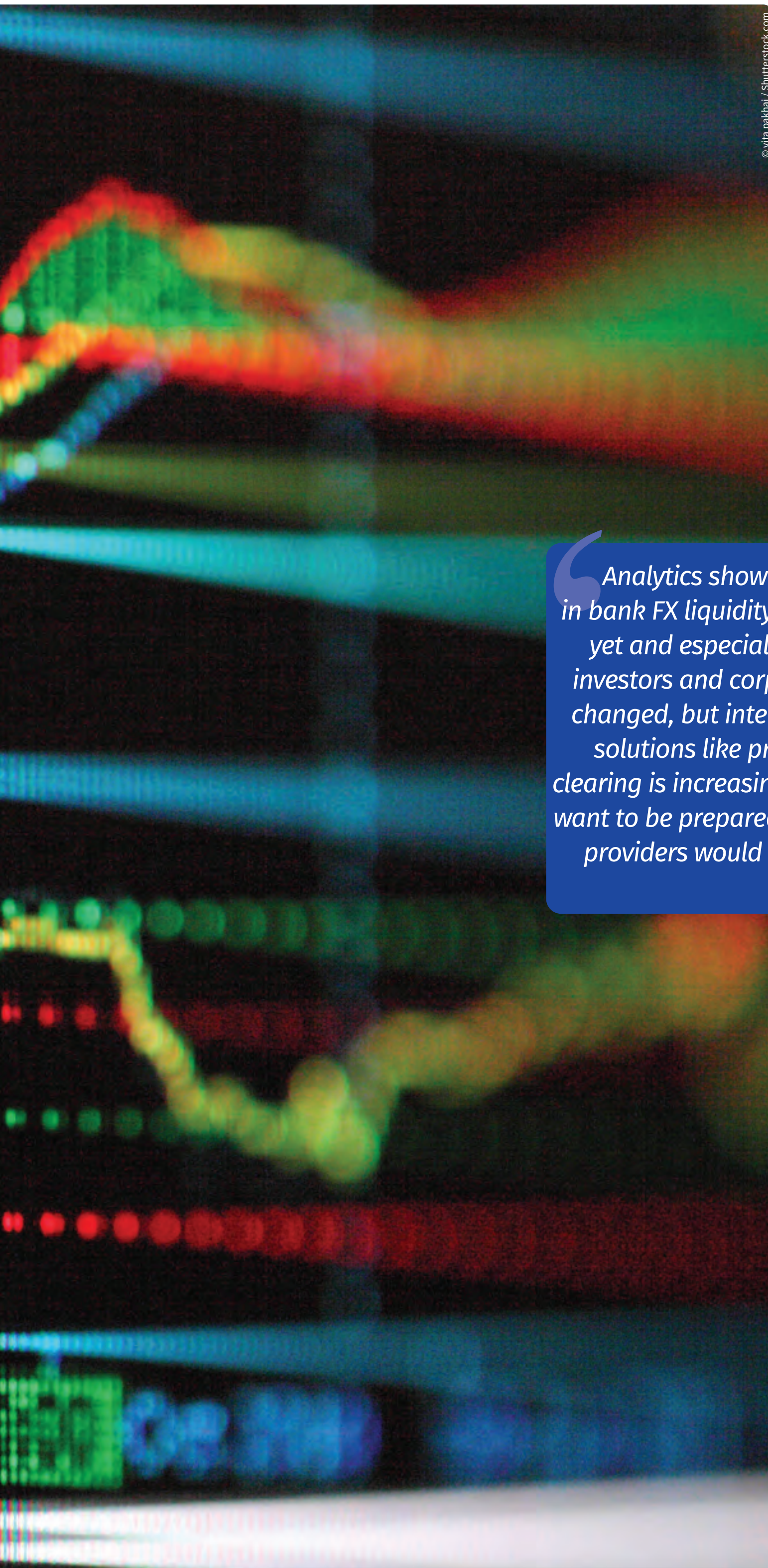
Peter Garnham: Has the reduction in bank FX liquidity affected the way that currency investors access the market?

Alfred Schorno: Our analytics show that the reduction in bank FX liquidity is not that significant yet and especially for real money FX investors and corporates only little has changed, but interest in organisational solutions like prime brokerage and clearing is increasing as these user groups want to be prepared if more bank liquidity providers would reduce their offering.

David Vincent: For me it is not really a question of being able to source liquidity from a non-bank or bank provider: what is important for our clients is getting the right price and accessing liquidity in volatile times. To do so clients need to easily access different venues and be able to aggregate this information in order to rapidly identify where the right/best price is and where the liquidity is.

In the end it is always the same story: investors need a wide range of connectivity adapted to changing market conditions. As a vendor, SmartTrade has the capability to access liquidity sources from banks, exchanges, ECNs, non-banks and multi-banks platforms. But unlike other platforms we are a neutral partner and we don't promote any type of trading or any liquidity venue. It is our clients' decision to choose which venues they want to connect to and to manage their liquidity provider relationships.

When there is a shift in the market and when banks are providing less liquidity we can react quickly and connect our clients to complementary sources of liquidity.


© vita pakhai / Shutterstock.com

> *Analytics show that the reduction in bank FX liquidity is not that significant yet and especially for real money FX investors and corporates only little has changed, but interest in organisational solutions like prime brokerage and clearing is increasing as these user groups want to be prepared if more bank liquidity providers would reduce their offering*
>
> *Alfred Schorno*

So the question should be: from a client's business and trading strategy point of view which liquidity provider will improve my market access in term of price and depth.

Peter Garnham: Connectivity is key for FX investors in that case?

David Vincent: It is clear that connectivity is a fundamental piece of liquidity management and is costly to maintain and resource intensive. But today is has become commoditised and what our clients are interested in is our value-added modules such as aggregation, smart order routing, order management and distribution, which allows them to improve their execution, reduces cost and differentiates their offering.

Peter Garnham: So if banks are providing less liquidity it is not impacting FX investors?

Alfred Schorno: Two years ago non-bank liquidity was not really on real money FX investors' minds where liquidity and credit was not an issue even with the execution constraints of an OTC market. The value proposition and incentives for change were probably questionable under these circumstances, especially to have either the will or ability to monitor counterparties than were often arbitraging between markets. What has changed today is the consideration given to other sources of liquidity.

As regulatory change has come into effect and will continue to affect both credit and liquidity then the value proposition changes. If credit is taken out of the equations, such as that of a hybrid market then the question comes down to accessing liquidity which can add value in terms of spreads and quality. Structural change has meant that the more strategic thinkers in real money FX are thinking about how to source liquidity, either closer to peers who have a real FX need or whom they will be able to offset risk against where the counterparty is warehousing. Quality of liquidity across the market will probably be the deciding factor if credit is somewhat de-coupled from execution no matter where it comes from, this could be banks or other sources.

Peter Garnham: How important is transparency in FX liquidity management?

David Vincent: As transparency has become more and more important, the first question clients are going to ask is how the price was generated. There are solutions in the market where it's unclear what happens to the price before it reaches you, it's very much a black box.

At SmartTrade we are fully transparent in the way client price is conducted because we supply a direct connectivity instead of a mark-up model. Our pricing is not volume based which means that our clients are not being charged more if their business grows incrementally and their trading volumes increase.

Alan Schwarz: As a disclosed trading venue, we at FXSpotStream are seeing a shift in where FX business is being done. We are fortunate enough to see our volumes grow 26% over the last year (May 2015 vs 2016), so we are bucking the trend.

What you are seeing in those numbers – and I think you see it in other venues that have a similar streaming offering – is that we have

© vita pakhai / Shutterstock.com

> *Connectivity is a fundamental piece of liquidity management and is costly to maintain and resource intensive. But today is has become commoditised and what our clients are interested in is our value-added modules such as aggregation, smart order routing, order management and distribution*
> *David Vincent*

seen a shift in liquidity and activity from anonymous venues to disclosed venues.

We were seeing that before the Swiss National Bank event last year, but post the event there was an increase in the trend given what happened to some of the FX prime brokers. We continue to see what feels like a shift in participants looking to exchange risk in a fully disclosed bilateral manner versus an anonymous manner. That is consistent with what we also see regarding more and more concerns with respect to market impact of their trading activity. The market is a lot choppier today than it was in the past and when people need to exchange risk there seems to be concerns for the market impact of exchanging that risk, thus people looking to exchange risk in a disclosed manner.

That said, I don't think we are seeing the end of anonymous venues. I think anonymous venues clearly have a place in the market.

Peter Garnham: Why are you seeing that shift?

Alan Schwarz: Credit is behind a lot of things right now. Prime broker credit is not what it used to be, and credit generally and risk profiles are higher on the list of priorities. If there is heightened sensitivity around risk, which there certainly is in the prime broking space and the prime-of-prime space, and there is heightened sensitivity to allocation of credit – even in a non-prime-broking relationship where a counterparty has credit for themselves, people are looking to understand pre and post trade who their counterparty is. That is why I think we are seeing volumes shift to disclosed venues.

Peter Garnham: How do you see FX trading venues evolving over time?

Alan Schwarz: We definitely see a shift in market participants wanting to make sure they understand who is on the other side of a trade both from a risk perspective, a credit perspective and a market impact perspective.

Alfred Schorno: The FX market has multiple types of participants with multiple reasons to transact. One size cannot fit all for this, so all participants should be able to choose the right execution venue, the right execution style, the right product, and the right post-trade clearing and settlement arrangements for the trade they need to do. The FX market needs to evolve into a truly hybrid model where OTC and Exchange trading, and bilateral and CCP settlement live alongside each other, so true best execution that considers individual requirements and the portfolio effect of the trade can be considered and managed.

However this is not the end of principal trading for risk transference. It is right that clients determine whether they need bilateral risk transference with their bank now or they wish to seek a price improvement while accepting the risk that they might not be totally filled, and then select the tools and venues that is likely to achieve the best outcome for their need.

For further information: **www.fx-mm.com**