How can retail flow add value in the institutional eFX market?

WBR Insights & CMC Markets Institutional

Contents

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Purpose & Methodology

In Q3 of 2020, WBR Insights surveyed 100 Heads of Trading, CTO's and similar from sell side brokers across APAC, EMEA and the USA regions, to understand the alternative views on whether retail flow can add value in the institutional eFX market.

In this paper we attempt to question the traditional perceptions of the FX trading environment, assess the impact of recent retail disruptors and analyse the importance of technology, all against the backdrop of a global pandemic and a looming financial crisis.

The survey was conducted by appointment over the telephone. The results were compiled and anonymised by WBR Insights and are presented here with analysis and commentary from CMC Markets contributors.

What type of organisation do you work for?

Which country are you based in?

EMEA	46%
APAC	46%
USA	8%

What is your job title?

Head of Trading	33%
CTO	25%
Liquidity Manager	23%
Other similar job titles	19%

Key Findings

Trading FX during a pandemic

Covid-19 hit the APAC region first in late December 2019 before it rippled through the global economy two months later. This caused widespread chaos and high volatility for the financial services industry, including forex markets.

There was a slight majority of respondents (55%) who said that their firms have not been using more alternative liquidity providers during the economic ups and downs of the pandemic this year.

Value in retail trade flow

Our research has shown that forex trading firms are conflicted in how they regard retail traders and the importance of the retail market on the industry. The growth of fintechs such as Robinhood catering to individual traders has been widely publicised in recent years making their impact hard to ignore. On the one hand, our survey data has revealed that the majority of respondents (52%) would be concerned by their trading counterparty having a retail background. However, on the other hand, 53% of our respondents cited that they see value in trade flow relating to retail clients, with 32% that said it was very valuable. A further 52% of our respondents also agreed that the integration of retail client flow can add value with regards to price construction and liquidity provision.

Need for diversification

In recent years, there has been an increase in the barriers to entry for forex brokers looking to access liquidity from traditional counterparties. Many traders still strongly believe that tier one liquidity providers can offer them a superior service however this is not always true. Many forex trading firms are unable to access tier one liquidity pools because of their size meaning they are forced to look at alternatives. Research showed that the priorities for traders are: minimisation of market impact, ability to source prices from more than one provider and ability to access a wide range of instruments. Non-bank market makers have emerged to bridge the gap in service for many institutions of various sizes. By looking to alternative providers that can offer unique pricing across multiple asset classes, forex firms can access a more complete solution tailored to their bespoke requirements.

Demands on technology

As the effects of the Covid-19 pandemic were felt within the foreign exchange markets, some forex firms sourced their liquidity from alternative providers to ensure they were able to provide a high level of service to their clients. Both retail forex traders and forex firms are reliant on their third-party liquidity provider's in-house technology infrastructure to maintain the consistency of their services; whether it is robust enough to withstand increased demand during volatile periods and if it can support their workforce working from home during lockdown restrictions.

Executive Summary

by CMC Markets Institutional

It is widely accepted that the foreign exchange industry exists in a constant state of evolution, something that is especially true in the fields of liquidity provision and price construction. The survey we have undertaken in conjunction with WBR highlights that, if anything, the pace of change is now more rapid than ever, and the extremes of volatility seen in 2020 made for an ideal proving ground to understand just how far this market has come.

The field was once dominated by a small number of the key players, but structural change for them - combined with the innovative use of technology by an emerging band of fintech's - has nothing short of revolutionised the functioning of the underlying market. However, polling of sell-side brokerages revealed widely differing understandings of what the new wave of market participants had brought to the table in recent years, suggesting there's still the potential for many to make significant efficiency (and commercial) gains.

With many respondents holding onto the belief that non-bank liquidity providers are simply unable to price consistently, especially when markets aren't functioning normally, this displays a now dated reality – and a point which was tested in the depths of the pandemic-induced volatility crisis. There has been instances with certain tier one banks when they were unable to make a market and the threat of dislocation loomed large. By utilising alternative sources such as CMC Markets Institutional who are able to leverage their internal flow to generate a new wave of liquidity, market participants could have achieved higher consistency of pricing.

Whilst it may be a step too far to claim that financial-technology-based liquidity providers alone saved the day, their commitment to using technology to improve market quality needs to be understood by all. The examples seen in 2020 illustrate very clearly that the world has changed prompting businesses and individuals to challenging their traditional ways of thinking.

Chapter One

Challenging Perceptions

As a new wave of non-bank liquidity providers have entered the forex market, buy-side firms are considering all the alternative options available to them when sourcing liquidity and are challenging their perceptions towards these new market entrants. Non-banks generate their own liquidity in a number of ways but will often require a critical mass from a large client base to be able to offer sufficient depth.

The primary venues and tier one banks have traditionally been perceived as the best option for forex traders when sourcing liquidity. Our research has shown that 66% of respondents think that tier one investment banks can provide a tier one service for their clients, where, in comparison, some of these newer market entrants could fall short. However, this view has been challenged in recent years, many forex trading institutions are not able to access these liquidity pools and are therefore dependent upon market makers and alternative liquidity providers.

Our data has revealed that many respondents fully understand and respect the position of market makers however there are still some forex traders who maintain a more negative perception. For those that held a positive view they stated the important part played in the functioning of financial markets and saw them as a supplement to automation technology.

Non-bank market makers can play a significant role in the current climate when forex brokers are struggling to access liquidity. By having a strategy which focuses on reducing market impact, internalisers are able to offer more competitive costs of trading over the longer term.

According to our research, 27% of respondents cited that it was very important for their liquidity providers to have a minimal market impact and a further 42% of respondents cited that it was somewhat important. These results highlight the need to understand the goals of a liquidity provider before agreeing to partner with them as well as maintaining an open dialogue so that the goals of the provider and the client are continuously aligned.

Our data revealed that the majority of respondents are looking for multiple avenues to source liquidity to increase the transaction flow and keep prices competitive. When selecting a trading counterparty, 42% of respondents said an aggregator STP was their preference, which was closely followed by 30% citing they preferred a bi-lateral trading counterparty. Interestingly the respondents who suggested their preference was aggregator STP contradict the 69% who said that minimisation of market impact was important to them.

There could be the argument that takers of liquidity feel they have better choice by working with a provider who has an appealing aggregation stack of tier one banks and native ECN feeds and therefore a greater chance of being able to get the trade away. However, if aggregation is not managed well, liquidity takers could run the risk of information leakage. Clients making larger trades looking for meaningful depth and consistent delivery could benefit from having their traditional perceptions challenged.

We asked our respondents to comment on whether they felt the negative perceptions of market makers were deserved, here's what they told us:

"They do tend to have a reputation of adding to the transaction cost."

"My decision would be split on the fact that they are important but also hike up the transaction price."

"No as a traditionalist and yes as someone who looks at the market from an automations point of view."

"The market is a place of opportunities. I wouldn't blame anyone for working smart and within a given compliance framework."

Those that disagreed with the negative perceptions:

"Market makers create movement that is why we have been able to speed up trades in the market."

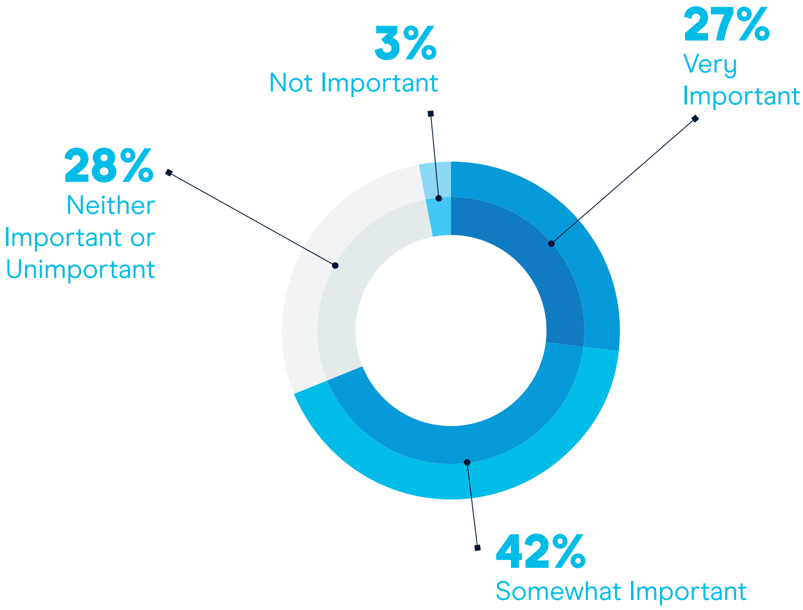
"They shouldn't be subjected to negativity because they are important in market movement."

"There are more who benefit from them than the ones who have a negative perception."

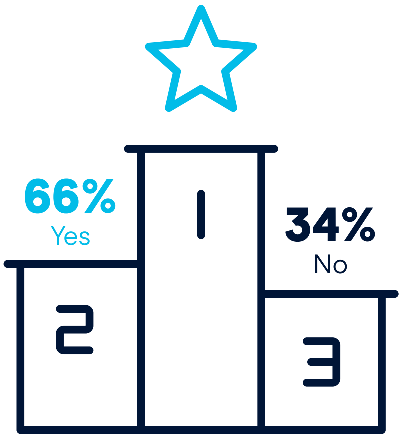
"We need them and only the smaller traders criticize them."

"I don't see them as a negative presence because they are like whole-sellers and we need them."

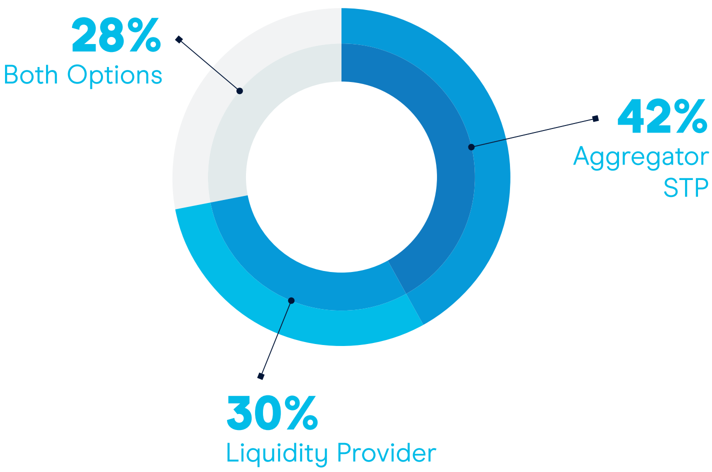
How important is it for your liquidity providers to have minimal market impact?



In liquidity provision does tier 1 in size, still mean tier 1 in service?



What would be your preference when selecting a trading counterparty?



We asked our respondents what they thought the terms DMA and 'prime of prime' meant to them. Some of their answers are included below.

"DMA is a market access tool and Prime of Prime is a liquidity broker facilitator..."

"Essential platforms in the market that are used for market access and potential creation of liquidity."

"Market access and Brokers are the first things that come to my mind."

"It's a long explanation but trying to keep it short, DMA provides market access and PoP creates liquidity thru brokers and top tier banks."

"Part of the market used for completely different reasons compared to each other."

"For me they are part of the trading market where one has electronic benefits and PoP provides broker leverage in FX trading."

"DMA allow smaller investors to access the market through hi-tech platforms and Prime of prime are large banks associated liquidity assistance brokers."

"DMA provides alternate and tech-based market access and Prime of Prime is a liquidity facilitator."

"DMA is an alternate market access platform and PoP create liquidity with large banks and associated brokers."

"DMA is an electronic market access platform and Prime of Prime is a broker liquidity platform."

"Respondents to the survey clearly had genuinely differing opinions when it came to understanding what value market makers can actually bring to the table.

Recent changes in the FX market, for example the ability for certain disruptors to invest in technology to drive down latency, the fact they can provide services across multiple asset classes and even the idea they can augment underlying market liquidity with their own flow, really does mean there is an opportunity to deliver a unique and complementary offering.

This is especially significant with regard to those who are able to leverage their own balance sheet and liquidity pools rather than simply recycling liquidity. Anyone judging the effectiveness of an LP on price alone is also missing the point. Headline rates count for little in isolation – can your LP deliver consistently, at meaningful depth and without causing market impact? If the answer is yes, this will result in a reduction in the overall costs of trading.

This market has been innovating quickly over the last ten years. We've already seen a new generation of non-bank liquidity provider gaining traction, so it seems highly likely that this genre will deliver further disruption – and accompanying benefits for the liquidity taker – in the coming years."

Simon Campbell
Group Head of Trading
CMC Markets

Chapter Two

Retail Disruption

The perception of retail forex brokers has often been negative with the view that many were using a B-book execution model and relying heavily upon data warehousing and internalised pricing. The traditional perception that this results in negative client outcomes is now under scrutiny. The idea that there is an A-book and B-book of clients is not always the case and this is often much more fluid dependent on the businesses risk strategy. Providers with a risk-averse strategy will be hedging not purely based on customer perception but based on overall risk appetite.

For smaller brokers defining the flow at a client or position level might be more important, but larger, tech-driven brokers are taking a different approach. Assuming flow is two way, brokers will match as many trades as possible before externalising in order to provide the most cost-effective outcome to clients through tighter spreads and better execution. Despite the negative market maker perception touched upon in chapter one, being one allows providers to offer these deep levels of liquidity, assuming they have a large enough book.

By applying this same model to the institutional market we have seen a new wave of non-bank or alternative liquidity providers born. These types of internalisers are becoming highly advanced with regards to their use of state-of-the-art technology to refine their pricing models resulting in a disruption of the traditional market players.

There have been many examples in recent years of emerging fintech firms disrupting the markets, for example, the Robinhood trading app, which has opened up the equities market to retail traders. According to our research, many respondents cited that they would not be surprised if, in the future, another giant tech firm were to emerge across other asset classes, including forex trading, resulting in further disruption to the industry in the future.

Whilst there are benefits to disruption through opening up and democratising marketplaces for both individuals and institutions, there are still many examples of inexperienced retail traders who can be negatively impacted due to a lack of understanding of how the markets operate.

This lack of understanding continues to damage the reputation of the brokers who provide the access. The wariness and traditionally negative view of retail trading firms was echoed by many of our respondents who would be concerned about their counterparty having a retail background. The opposite however was seen by the 52% who could see the value in the integration of retail client flow for price construction and liquidity provision showing there is an opportunity for retail providers to prove themselves as having an important place in the institutional FX market.

We asked our respondents where they saw potential for disruption in the future across all asset classes. Some of their answers are included below.

"I wouldn't be surprised if another tech giant take a big step into the finance and capital market automations and application based trading world."

"I would like to see how far disruptions can go in the FX side of investments."

"Like Robinhood there are organizations and non-core participants who are trying to achieve a wider reach in the market. FX is the next big asset class to witness disruptions."

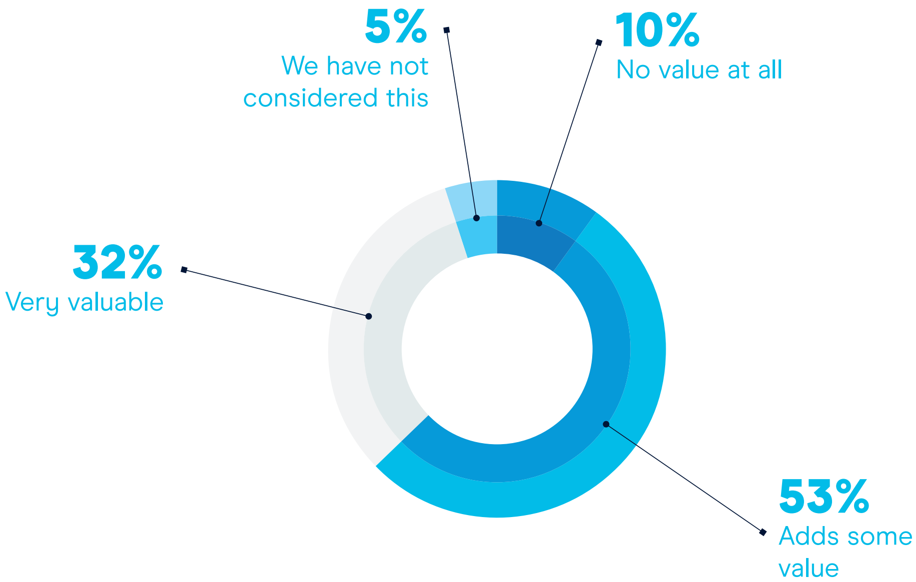
"There are numerous organizations trying to imitate the model created by Robinhood and some of them are moving up the competitive ranks."

"I expect more non-core companies intervening in our line of business and most of them will come from the technology sector."

"I believe that there could be more disruptions in the equity market itself because of its speed. FX and commodities could also witness disruptions."

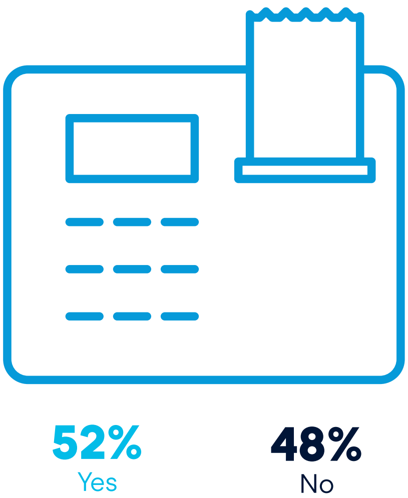
"Digitalization will play a bigger role than any other disruption. It all depends on how every organization uses this technology."

How much value do you see in trade flow data relating to retail clients?



Do you think the integration of retail client flow can add value when it comes to price construction and liquidity provision?

When selecting a liquidity provider - would you be concerned about your counterparty having a retail background?



"The data shows that there's real confusion when it comes to what people feel about working with those counterparties who have exposure to the retail market. Tales abound covering subjects as diverse as sharp practice from rogue operators to retail investors making misguided decisions, with this latter point being especially visible in recent months amongst US share trading platforms like Robinhood. They have certainly had a disruptive influence, which has put a renewed focus – and additional scrutiny - on the fintech world in general, but make no mistake, there's a lot of positives emerging from this revolution.

It's important to bear in mind, the retail market is rigorously policed by regulators especially in tier one jurisdictions such as the UK, Germany, Singapore and Australia. Furthermore, in order to serve thousands of retail clients – and meet the complex regulatory reporting requirements - these providers need robust systems built on the latest technologies. In other words, that's a cohort of counterparties who are collectively sitting on a significant volume of accurately catalogued flow.

What's more, those operations with a global footprint have the flexibility to engage on local terms of service, something which the smaller traditional institutional brokerages simply cannot do in an efficient manner. The assumption that all retail brokers are running books of business on an excel spreadsheet from a back street office couldn't be further from the truth and with the larger participants continuing to invest heavily in technology, innovation and with it disruption, seem inevitable."

Richard Elston
Group Head of Institutional
CMC Markets

Chapter Three
Technology

As the credit conditions have been squashed, many forex brokerages have lost their prime broker relationships and been forced to look for alternatives. The popularity of non-bank market makers has grown as they are able to fill this gap. Technology providers have designed innovative and customisable solutions for forex traders, to increase their execution and efficiency, saving them time to focus on larger and more complex trades.

Only 19% of our respondents said they were using systems built in-house to help them source liquidity therefore the majority of businesses are looking at least in some part to a third party to support them with their trading technology.

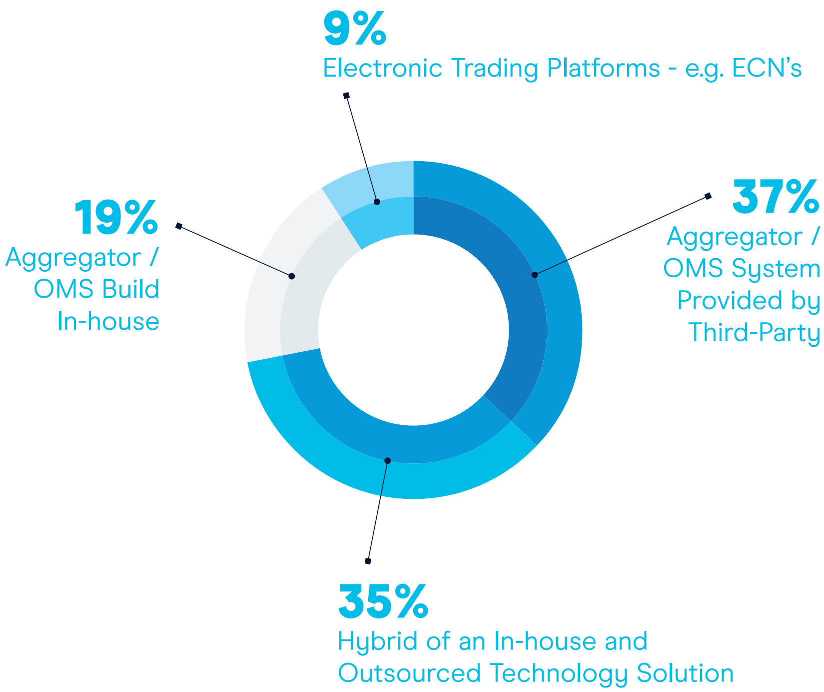
Many business will be looking to outsource as it allows them to free up time to focus on other more commercial areas of the business and avoid having to employ large development teams. Considering the range of asset classes our respondents told us they were trading, there is also the added complexity of gaining access to such a vast array of markets on a global scale. However when relying on a third party it is important to consider the robustness of their technology and infrastructure, especially in volatile markets when there is most likely to be lower levels of liquidity available.

When considering the key requirements for selecting a trading platform the majority of our respondents ranked the range of connectivity as their most important factor followed by the reputation of the provider.

Business will often have pre-existing relationships with suppliers and the overall cost of on-boarding new providers can be high, particularly if there is large amounts of development needed. Providers that are agnostic in terms of connecting to technology hubs or ECN's for execution will therefore be most appealing.

Choosing a technology provider with a strong reputation is likely to be of even greater importance in 2020 and beyond. Through the combination of moving to remote working and the extreme volatility seen in the markets it is important that forex brokers can rely not only on the technology, but also the service of their partners.

What types of technology are you implementing to help you source liquidity?



What are the key requirements you are looking for from a trading platform?

(Please rank the following on a scale of 1-4, 1 being the lowest and 4 being the highest.)

3.23
Range of connectivity

2.35
Reputation of provider

2.24
Costs: off-the-shelf platform costs or set-up costs

2.18
Latency

"The research shows that whilst many respondents acknowledge liquidity providers can add value, it's arguably just as important to understand what goes into making for optimal liquidity provision. Technology sits at the heart of today's markets with a wide range of low latency connectivity providing excellent price discovery, but at the same time, this means that third-party systems have to be optimised at every stage.

To this extent, brokers such as ourselves have invested heavily in developing the very best technology stack possible. After all, a trading business can only achieve a genuinely global reach if it is powered by robust infrastructure. This is something CMC Markets is recognised as having achieved through the development of proprietary technology by our team of over 100 in-house developers, co-located in London, Vienna and Sydney.

As a result, our reliability has not only benefitted retail customers, but also offers confidence for those institutions who are looking for a high quality and stable liquidity partner. Furthermore, our modular approach gives counterparties the flexibility to take only the components they want, accessed via an API, in turn allowing for seamless integration with their own systems."

David Fineberg
Deputy CEO
CMC Markets

Chapter Four

The Current Trading Environment

As uncertain times look set to continue the use of trading technology will be paramount for forex traders seeking to source liquidity in disorderly markets. Our respondents have cited that their firms have implemented a variety of different strategies and systems to source liquidity this year with 45% of respondents stating that they had increased the number of alternative providers used.

At the height of the Covid-19 pandemic, we saw two major dislocations, firstly in gold and secondly, outside of the FX market, in oil. The current environment has meant institutions need to question whether they have a wide enough breadth of liquidity sources available to them in order to best protect themselves for the future.

Use of 'innovative trading models' and 'moving away from traditional methods' were cited by our respondents as coping strategies, once again pointing to the idea that technology provides opportunity, however there is clearly a large part of the FX industry who maintain a conservative view. We have already explored in this paper a number of reasons why the 55% of respondents who are not using alternative liquidity providers may have chosen this strategy; traditionally negative perceptions of market makers, the status of the tier one banks or the resources involved in on boarding a new supplier, either from a commercial or time perspective.

For those now looking at strategies for facing the next black swan event, alternative, technology-focused liquidity providers look to position themselves as having an important role to play by offering multiple aggregation and price discovery opportunities.

We asked our respondents how their firms have coped with sourcing liquidity during the volatile periods of 2020 caused by the Covid-19 pandemic. Some of their answers are included below.

"Liquidity has been tough and we are continuously seeking new methods of maintaining liquidity."

"Good two-way trading has been at the center of generating liquidity."

"Moving away from traditional methods has made a big impact."

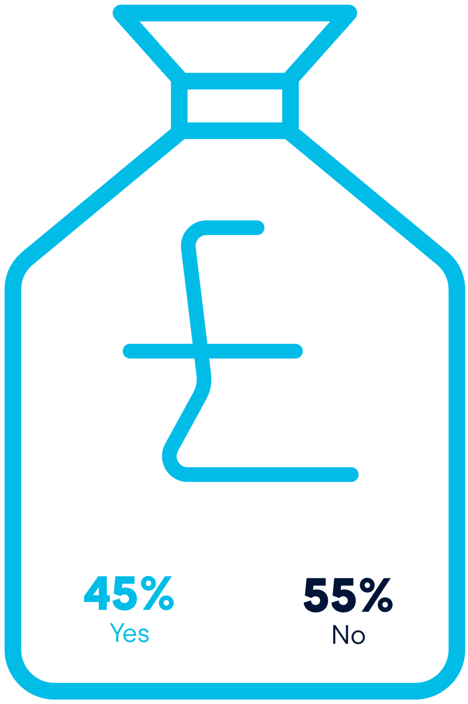
"We operate with a strong team of FX experts that have helped us cope with this situation."

"Extensive use of digitized strategies and innovative trading models."

"Liquidity has been a effectively achieved through smart analytical and execution tools."

"Our scenario modelling tactics are more than helping us right now."

Have you used more alternative liquidity providers during this time?



“The shift to working from home combined with sharp increases in volatility presented a unique set of challenges for market participants. Whilst survey respondents did confess to finding some issues at times, it seems clear that the technology in use allowed many providers to continue offering a high-quality service throughout.

Arguably this was aided by the wide distribution of liquidity providers, which in turn could have helped with price construction even in times of threatened market dislocation. It did however mean that those liquidity providers with broad and robust connectivity – and that included ourselves – ended up in a stronger position than some smaller brokerages.

With the ongoing innovation seen in the FX market, the industry can be expected to have an even tighter focus on realizing marginal gains. As institutions of all sizes look to improve financial performance, those challengers with something new to offer – and their clients - stand to benefit. Using retail flow as an additional input to generate enhanced liquidity surely now looks even more attractive. This illustrates why we should continue to welcome innovation and positively embrace the disruptors.”

Simon Campbell
Group Head of Trading
CMC Markets

Conclusion

Whilst the economic recovery from the Covid-19 pandemic is predicted to be longer than the 2008 financial crisis, the pandemic has provided an opportunity for many to question their strategies and benefit from new technology. There has been a clear acceleration in development from the most agile businesses, whilst shining a light on those who have been slow to react to the change of pace.

Popularity of fintech's with a large retail client base has grown this year, as has scrutiny of their operations. For providers whose technology has proven to be robust there is now an opportunity for diversification.

Well established retail FX brokers have the ability to step up into the institutional space, with initiatives such as the FX Global Code setting a common standard and promoting a fair, open and transparent market. There is a clear divergence of opinion when it comes to integrating the retail and institutional trading worlds, however the majority of our respondents could see the value in the trade flow data coming from a retail provider. This trend looks set to last as financial markets continue to be democratised and more genuine internalisers of flow result in greater depth of liquidity.

The presence of a new wave of non-bank providers (utilising the critical mass of a retail base) has proven to be valuable throughout the crisis, providing stability in particularly volatile periods. With the opinion on those who also have established retail client books still mixed, hopefully, this will help to change perceptions in the future.

About CMC Markets Institutional

CMC Markets has operated since 1989 as a financial technology (fintech) organisation with the aim of improving accessibility to the financial markets. We provide our tools and solutions to both individuals and businesses.

Our institutional team provides non-bank liquidity to a global client base of brokerages, funds, banks and dealing desks. Through a single connection, our clients have access to multiple asset classes worldwide allowing them to seamlessly execute their chosen strategy and increase revenue potential. We are able to deliver price construction and reference from multiple primary and alternative venues, as well as executing orders on our own books ensuring we are reducing the risk of market impact and providing the best offering for our clients.

As of November 2020, CMC is now a signatory to the FX Global Code, we are one of the first sign-ups from a traditionally retail business demonstrating our commitment to maintaining effective functioning of the wholesale foreign exchange market as well as our shift to becoming a non-bank liquidity provider.

We are regulated in multiple jurisdictions, under the Financial Conduct Authority (FCA) in the UK, by BaFin in Germany, the Australian Securities and Investment Commission (ASIC) in Australia and the Monetary Authority of Singapore (MAS) in Singapore.

To find out more visit: **cmcmarkets.com/institutional**

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