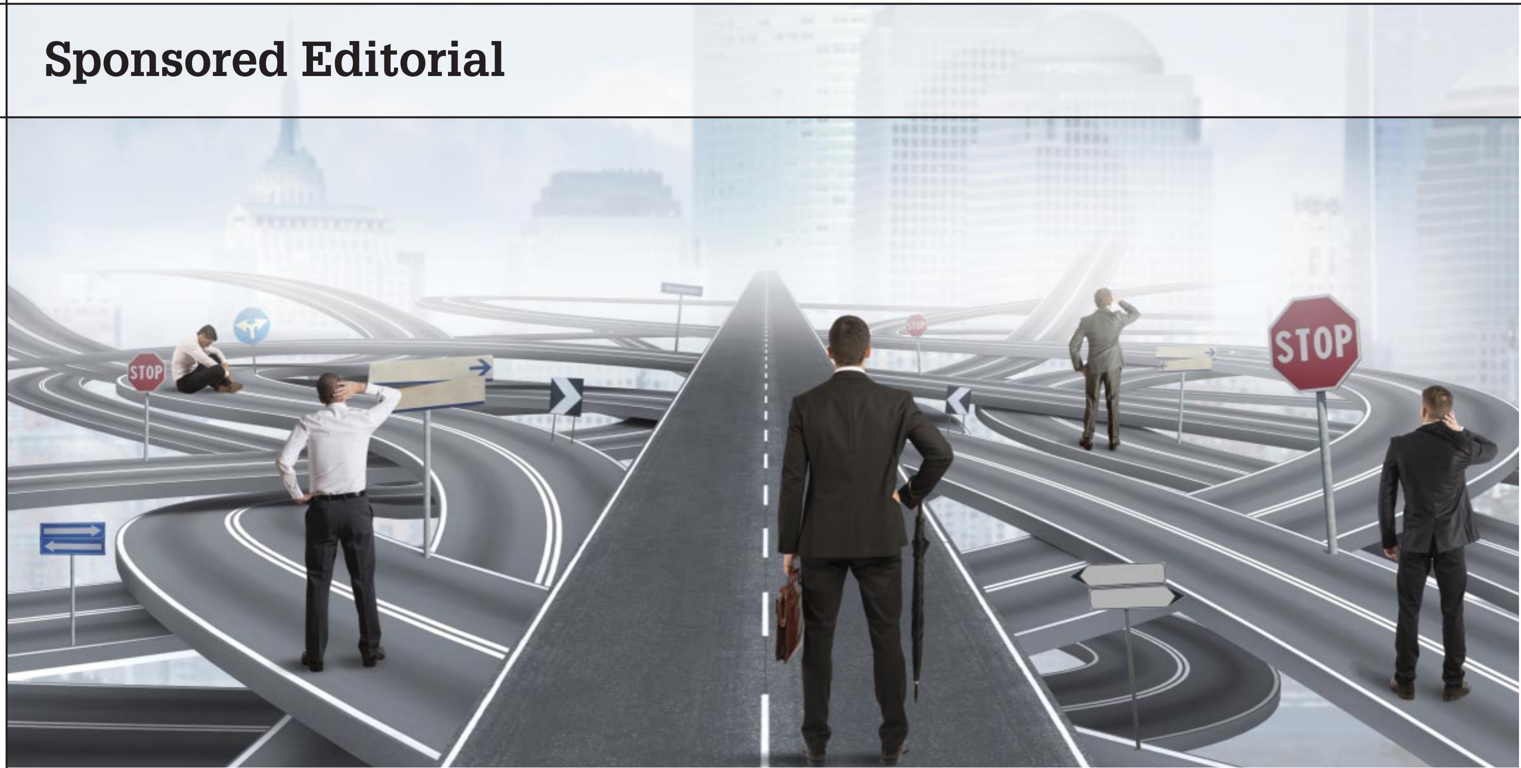

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On the Path to Prime Brokerage

Many mid-sized institutional FX brokers are clamouring for professional, institutional trading platforms that can give them access to optimised liquidity and a creditworthy counterparty. Prime brokerage is an attractive solution because it addresses these issues, but it might not be the right solution for everyone, say Citi's Alex Knight and Sasha Serebrinsky.

The small to mid-sized institutional FX broker community has experienced explosive growth over the past decade, due mainly to the democratisation of the FX market through easier access to pricing, credit and liquidity. In addition, new technology developments give firms the ability to more effectively distribute products to end customers, allowing these businesses to gain traction in the market.

Low set-up costs and readily available technology have also been instrumental in this segment's development. Today, it is possible to set up a small brokerage on a shoestring – institutional start-ups can purchase a MetaTrader 4 white label solution and outsource much of the technology to a MT4 bridge provider or other technology providers. This makes it viable to run lean operations with minimal staff.

Currently the biggest challenge in the market is oversaturation, and therefore small to mid-sized players need to optimise their operations in order to differentiate themselves. To do this effectively, they require three things.

Firstly, they need to be able to deliver consistency and quality of pricing across the right depth of book, the right currency pairs and in the relevant time zones to support the activities of their customer base. However, pricing is not just about the top of book price, nor is it solely about commission. Firms need to look at the whole package offered by their liquidity providers, including reject rates, the quality of execution in difficult trading conditions and the depth beneath the top of book liquidity.

Secondly, mid-sized brokers must ensure their financial counterparties provide the appropriate level of customer service. Many firms, particularly those running lean, need to have access to well-trained customer service representatives who can help them get set up and also respond to queries throughout the 24-hour trading day.

Thirdly, in order to best serve their clients, every broker must have security of funds, something often forgotten until a crisis occurs. The end customer expects this from their broker; however, the end broker may be passing the funds onto another counterparty, which may in turn pass them onto another and so on. The longer this chain becomes, the more risk is introduced. Conversely, the closer the underlying retail customer is to a credit intermediary that has virtually unlimited access to the market, the more secure their access to liquidity will be.

A Growing Need to Tailor Liquidity

One consequence of the rapid growth in the FX market as a whole has been fragmentation of liquidity and an increase in recycled liquidity, as the chain between the market maker and the genuine market taker, or end consumer, lengthens. The upside to this development is that top of book prices have become consistently tight; however, the downside is that when firms start trading on that liquidity, it may turn out to be phantom. Quite often there is double, triple or even quadruple dipping, as genuine liquidity in the market hasn't actually increased.

Although, in theory, mid-sized firms can access an ocean of anonymous liquidity, this liquidity can move, shift and even evaporate, and as a result the spreads widen. In addition, particular types of flows are not palatable for certain liquidity providers, who will, in turn, widen their pricing.

Many mid-sized brokers are becoming dissatisfied with the quality of liquidity and execution they receive, and ultimately they want to find a way to shorten the relationship chain. They have begun to appreciate the value in having greater control over the liquidity source and composition of that liquidity, something not readily available when accessing recycled liquidity. A mid-sized firm rarely knows where the liquidity comes from other than that it is aggregated.

Furthermore, each firm that is involved in the liquidity chain will need to cover its own costs and generate an acceptable return. The longer the chain, the higher these costs become.

In order to address the specific liquidity issues of the small and mid-sized brokers Citi launched CitiFX TradeStream in 2012. The platform provides tailored liquidity services not only to shorten the relationship chain, but also to give mid-sized firms a greater degree of influence over the type of liquidity they consume.

TradeStream builds on Citi's existing credit relationships with other banks and the price-making hedge fund community. By leveraging its existing network and building an aggregated pool of liquidity, which is distributed using Citi's systems and platforms at a low cost, Citi's customers are only one short hop away from the actual price maker.

By working closely with the underlying price makers, Citi can direct flow to those who will find it more appealing and ultimately provide better pricing.

For example, a European-regulated mid-sized broker client of Citi's is of the size and sophistication that puts it firmly on a path to prime brokerage, but it's not quite ready to take that step as yet. It has unique liquidity needs: a portion of its flow is sent through on a straight through processing (STP) basis and not risk managed; however, it does risk manage another portion of its flow and periodically needs to offset its risk in the market.

The ticket characteristics also differ between these two flows: the STP flow is generally made up of a large number of low value tickets, while the hedged flow generally tends to be made up of fewer tickets, but with larger amounts on each ticket.

Citi worked with the client to provide two execution solutions involving two technology solutions: the STP flow goes through a fixed API and manual hedging is done via a platform. More significantly, the liquidity that underlies these two solutions is also different. For the STP flow, TradeStream provides optimised liquidity that is competitive at top of book and also includes specific liquidity providers that are better able to monetise the flow. For the broker's manual hedging, TradeStream delivers a different liquidity stream that is optimised for larger tickets and the specific currency pairs in which it requires hedging.

Importantly, both execution solutions tie back to the same back office and reporting systems. Hence, regardless of where it executes and which stream is used, the client can see its trades centralised in one back office tool, CitiFX Click, the same technology that is rolled out to Citi's prime brokerage customers.

Is Prime Brokerage Right for You?

As illustrated by the European broker, there comes a time when mid-sized firms come up against the limitations of off-the-shelf solutions and begin looking for something more sophisticated, maybe with an eye on prime brokerage as their desired solution. Essentially, they want to face a credible counterparty and get as close to interbank liquidity as they can, as well as have access to good customer service. Many are attracted to prime brokerage because it can provide those three elements.

However, the conventional prime brokerage business hasn't penetrated into the mid-market institutional arena for a number of reasons. Firstly, despite a high level of STP and technological advances, the establishment and maintenance of a prime brokerage relationship is a fairly resource-intensive process. In particular, it is front-loaded, requiring investment in documentation, credit evaluation and technology integration, and reasonably operationally intensive on an ongoing basis. This makes the area challenging for a client segment that falls below the radar of the conventional bank prime broker space to move into.

In addition prime brokerage – in its purest form – often requires the customer to develop and maintain its own liquidity relationships. Those who haven't previously gone through the process will often underestimate how much time this takes and what is required in terms of skills, resources, relationships and critical mass, for example generating enough business for the counterparties to make the arrangement viable.

Thus, after an in-depth discussion, many clients come to the conclusion that they are still a year or two away from prime brokerage, or that they might not need this even in the long term. This was the case for a large, well-established institution, which runs a lean operation with a staff of six or seven people. It is primarily focused on distribution, so its in-house skills and organisation reflects its business objective of accessing customers.

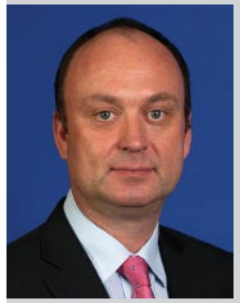
Once it learned that moving to a prime brokerage model would mean increasing its headcount by three or more staff to sustain the required liquidity relationships and operational overhead, the client concluded that this wasn't the right move at this stage of its evolution, and instead opted for TradeStream. Having a complete picture of what prime brokerage entails meant the client could build its business in a more thoughtful and considered manner.

TradeStream is usually seen as a stepping-stone to prime brokerage, but clients have moved both ways. Another customer moved from a retail broking platform to prime brokerage, and then almost immediately decided to go with TradeStream instead. Again, this client felt that the operational processes it had to manage as part of the prime brokerage relationship outweighed the limited benefits it received from direct access to liquidity providers. But it still wanted a quality credit counterparty and access to good liquidity, both of which Citi could provide through Tradestream.

However, there are many customers that do grow to the extent that they are capable of – and can add value through – managing the liquidity provider relationships and the operational requirements. A number of them, who are currently using TradeStream with a margin trading account, have indicated that they plan to go through the prime brokerage on-boarding process as and when they feel the time is right.

It is clearly advantageous to begin the relationship with TradeStream, as it makes the transition to Citi's prime brokerage fairly easy because much of the client on-boarding that is done for a TradeStream relationship, in terms of Know Your Customer (KYC) and anti-money laundering (AML), doesn't need to be replicated if a client wants to expand to a full prime brokerage relationship. In addition, TradeStream customers are using many of the same tools that they will go on to use in prime brokerage, such as CitiFX Click.

PERSONAL BIOS



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