Boutique prime brokers offering a far more customised FX service

The prime brokerage industry is facing some of its toughest times since the financial crisis, squeezed on one end by stricter regulations and at the other by falling profits. But, as Caroline Henshaw now reports, mid the chaos, a new generation of agile and sophisticated boutique FXPBs have emerged that can offer clients a service tailored to their diverse needs.

FX prime brokers play an integral role in currency markets by providing the clearing services and credit that financial institutions and exchanges from around the world need to trade with each other. They stand as an intermediary between funds and two important sets of counterparties: institutional investors with shares to lend for short selling, and commercial banks with money available for margin loans. But the rapid growth of global FX markets, which are now worth more than $5 trillion a day, and the increasing diversity of players trading in them has forced FXPBs to evolve far beyond their original functions from when they first entered the scene in the 1990s.

**BROADER ROLE**
Prime brokers now have to cater to a broader range of investors all with varying needs, including other brokers, high-volume traders, hedge funds, asset managers, CTAs and smaller financial institutions.

“Clients’ growing need for a more personalised service has opened up a greater role for prime brokerages, which provide a comprehensive package of services across multiple asset classes,” said Saul Zaidman, Head of Business Development at Finotec, a boutique London-based FXPB. “As a ‘boutique’ prime broker, Finotec provides small to medium funds with the advantages of first-tier bank prime brokerage. The popularity of boutique FXPBs owes much to the promise of managing operational risk and reducing costs,” he adds.

And it’s not just the clients that have become more varied: the range of liquidity pools available has also multiplied, meaning FXPBs also play a crucial role in ensuring clients are connected to the right venue for their trading strategy.
**FX BROKERAGE OPERATIONS**

**Boutique prime brokers**

It doesn’t matter if you are in FXPB or a fish monger, business is all about relationships.

“Traditionally, FXPBs have offered market access to diverse liquidity providers as well as operational efficiencies in terms of cross-netting of open positions and flexible collateral management,” explained Nick Mortimer, Head of Prime Brokerage and Clearing at CFH Clearing. “However, with the new requirements being set by Dodd-Frank and EMIR regulation, FXPBs are now looking to assist their clients with their obligations to clear, report and margin requirements.”

George Grech, head of the Trade Desk at EXANTE, says that the more varied customer base in FX markets has also driven a growth in demand for services that can connect across multiple asset classes. “Clients now demand prime brokers that are multi-product,” he said, adding that many “existing FXPBs have not expanded their universe of tradeable instruments” enough to keep up with this trend. “The EXANTE platform is multi-product, multi-asset-class, multi-currency. Clients can trade the world of financial instruments, not just FX, from one account,” he states.

The increasingly complex needs of clients have also attracted more technology solutions providers into the space and helped to drive the rise of boutique prime brokers.

**THE EVOLUTION OF FXPBs**

Stricter regulations have also forced prime brokers to assume more responsibility in the transaction lifecycle. A recent study by KPMG found that tightening global regulations around capital management and trade reporting have placed “renewed focus on issues such as safety of client assets, in terms of custody, segregation, and management of clients’ unencumbered assets”.

“Prime brokers will need to rethink the control environment that governs their operations and system platforms,” it added.

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**THE RISE OF BOUTIQUES**

Boutique FXPBs offer many of the advantages of first-tier bank prime brokerage combined with faster and more cost-effective solutions for trading, back-office and risk management, and a more specialised and flexible service. They connect clients with bank liquidity pools and then clear the transaction, meaning that they also avoid any conflict of interest with their own trading operations as with traditional prime brokers – an important consideration given the regulatory push for transparency.

“FX was traditionally used as a hedging mechanism, it is now considered a primary investment tool,” said Zadman. “FX prime brokerage has thus evolved into a highly competitive market by extending liquidity to specialised brokers, algorithmic traders, hedge funds, money managers and more.”

The shift toward boutique FXPBs has also been driven by new financial regulations, such as Basel III, that require brokers to hold more capital, and which have forced a major consolidation and rethink in the sector.

Tighter regulations have pushed up the cost of running prime brokerages, while revenues have been dragged down by a drop in per ticket volumes, making it increasingly uneconomical for banks to service smaller clients.

Facing some of the toughest challenges since global financial crisis erupted in 2008, bank-run prime brokerages have become increasingly ruthless about the size and quality of funds that they are willing to work with.

Rabobank has already closed down its FXPB operations, while other banks are believed to be cutting back some of their services to clients not seeking access to FXPB as part of a broader package of services.

Market sources say the prime brokerage units of many banks have recently doubled their minimum annual revenue requirement from an individual hedge fund client to between $400,000 and $500,000.

**HUGE OPPORTUNITY**

This exodus has left a crucial opening for boutique FXPBs to service the smaller funds with between $100 million and $1.5 billion of assets under management that make up 90% of the hedge fund industry.

It also means boutique brokers are becoming increasingly crucial to meet the growing demand for capital and leverage among smaller and more specialised players as risk appetite has started to return to the market.

“Demand from customers who have been exited from bank FXPBs that have made the decision to step away from the business, and the constantly increasing entry criteria into existing FXPBs due to credit tightening, have brought about a rise of new FX credit intermediaries and prime of prime players,” said Mortimer.

Didier Essemini, the founder of Finotec, believes that Rabobank’s decision to close down its prime brokerage operations has already helped to drive a four-fold increase in the number of new clients approaching Finotec. And, with an estimated 700 retail brokers and 70 million clients set to enter the market in the near future, the future opportunities for FXPBs are huge.

But as the costs of starting up new firms and trading continue to rise, companies are also becoming more picky about choosing which FXPB to work with.

**PICKIER CLIENTS**

When looking for a prime broker, investors have typically looked at price, access to hard-to-borrow securities, credit-worthiness and access to term lending. This includes single account settlements, full transparency in execution, margin lending, capital introduction and more.

Stricter regulations mean customers now expect FXPBs to also assist with their more stringent clearing, reporting and collateral obligations as standard – and help them manage risk at the same time. The emphasis on costs means access to multiple and varied liquidity pools is a vital differentiator for boutique prime brokers; research suggests traders can cut spread costs in half if they have access to three or more liquidity providers, compared to just one.

“For us, the main client driver is always the ability to tap into the major liquidity venues in the world. Secondly, it’s our universal back-office and risk management solutions that drive business to us,” said Talei.

Clients expect this broad range of functionality to be incorporated in
FX BROKERAGE OPERATIONS

a complete front-to-back solution that can cover all of their managed services, technology and execution needs in one package that can be rolled out in a matter of weeks.

The growth of high-frequency and algorithmic trading strategies also means that speed has become a crucial factor for many clients when they choose a prime broker. “Latency and slippage are key concerns and will not be tolerated by clients,” explains Grech.

Tibco StreamBase’s 2014 FX Trading and Technology survey found that almost half of FX market participants are already trading algorithms, and a further 27% are planning to do so in the future, meaning latency issues are also set to become even more important in the future.

On top of this, as a boutique FXPB, being able to offer customised services and relationship management is particularly key. A study by EY found that one of the key challenges faced by prime brokers is to “add clients, but reduce costs by leveraging efficiencies and economies of scale...because of the large amount of transaction customization and client relationship management required in the business”.

But where traditional prime brokers have struggled, boutique FXPBs are able to offer clients solutions tailored to meet their specific needs.

“It doesn’t matter if you are in FXPB or a fish monger, business is all about relationships and building win-win opportunities,” said Patrick J O’Brien, Communications Director at EXANTE.

“The key to being a successful PB is providing a balance of fast technology with front to back systems able to service clients fully,” agreed Essemini. “The continued growth in our monthly volumes can be attributed to our clients enjoying lower trading costs, the offering of back-office functionality, but mostly to our personalised level of service,” he added.

CULTIVATING RELATIONSHIPS

Boutique prime brokers are also seeking to build deeper relationships with tier one investment banks and 10 other non-bank institutional liquidity providers. In a bid to capture more emerging market currency investors, it has also partnered with local banks in various countries to cut trading costs.

The company works with multiple different software vendors, ECNs and aggregators to allow their clients to choose between multiple or single technology solutions. Finotec provides access to the major ECNs like EBS, Currenex, Hotspot, FXall, and can also link to the secondary market place operated by the liquidity providers.

Grech explains that, as well as offering improved trade access via platform or api, execution, clearing, real-time risk-management and exceptional liquidity, EXANTE has also been investing in cultivating its key strategic relationships with industry partners to make it stand out from the crowd.

“More and more banks are willing to provide liquidity,” he said. “A sound business in a strongly regulated jurisdiction, track records and relationships are important to keep in mind when building bridges to your bank.”

Price Markets has also been working to make its offering more flexible by on-boarding an aggregator to simplify the process of connecting to multiple venues and single-bank providers with a universal credit limit and pre-trade credit checks. “We know the ins and outs of most liquidity venues, so once we understand the requirement of our clients we direct them to the venue which suits their objectives,” explained Talei.

Last year CFH Clearing launched its ClearVision suite of products, giving prime of prime customers the ability to manage liquidity, risk, collateral and reporting all within one platform and offer clients access to more diverse liquidity.

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the key challenges faced by FXPBs, particularly when it comes to sophisticated operations such as real-time maintenance of exposure and instant kill switches across all liquidity sources.

“FXPB are essentially technology companies with an FX wrapper,” said EXANTE’s Brien.

Boutique FXPBs have taken different strategies to do this, with some using solutions from providers such as Flextrade, PXM and ETG, while others have integrated them into their own suite of products.

WIDENING CLIENTS’ MARKET REACH

Another key element of the business today is understanding how each client makes their profits, and catering to that need.

“Cost-cutting, tighter capital and leverage requirements, more demanding clients and the paucity of client profitability measures are all real challenges for prime brokers that want to respond effectively to changes in the hedge fund industry,” said EY’s report. “To meet these challenges requires prime brokers to be able to ascertain each client relationship’s profitability.”

Many FXPB teams have even started to diversify into “concierge services,” which allow them to act as a gateway for clients who may be seeking new trading, business and partnership opportunities.

Regulatory changes mean some companies may be choosing to enter or exit new market segments, and FXPBs can help with introductions. As FXPB are becoming more integrated into futures clearing businesses, it also offers opportunities to look at clearing other asset classes.

“As the credit intermediary the FXPB opens up relationships with other ‘like-minded’ clients and therefore widens your reach across the market,” said Mortimer.

Some FXPBs are taking this even further by building their own alternative trading venue. As Essemini explains: “In the longer term, Finotec wants to create an alternative trading venue to the FX OTC market, with an exchange that offers clients swift aggregation, easy and fast connection, a multi-account management system, plug and play bridge to their existing servers and full transparency without price manipulation.”

“This will allow Finotec to offer full prime brokerage combined with the optimal technology to facilitate institutional and retail brokers business while still ensuring that their end clients benefit from the best execution and service. This is our vision, and we’re determined to make it happen,” he states.