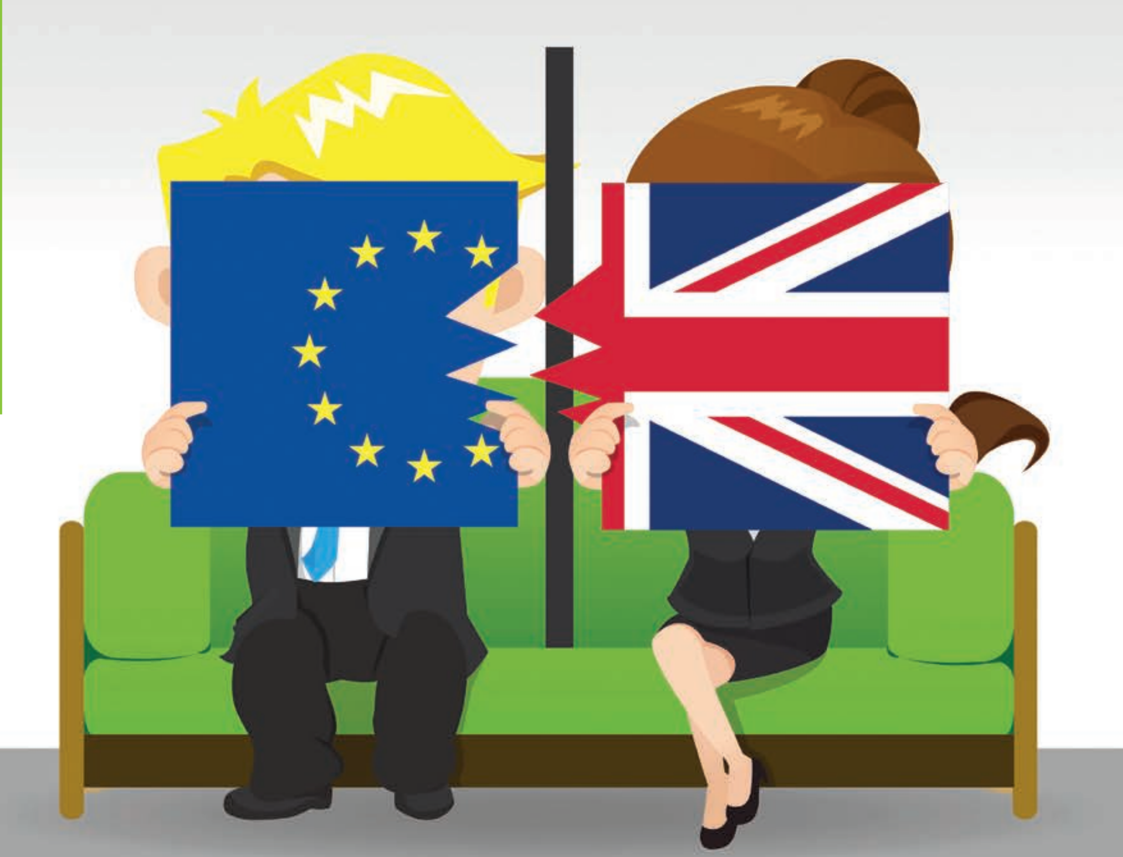

Coping with Brexit

How electronic platforms held up during the world's messiest divorce

Nicholas Hastings investigates how platforms and trading venues coped with volumes and market volatility during the recent UK referendum event.

The night of June 23, 2016 was the historic night that Britain voted to leave the European Union and triggered the start of years of negotiation in what has been billed as the messiest divorce in history. How it will all end remains to be seen but the process has been made easier by Britain's refusal to join the single currency, the euro.

Of course, the referendum focused the attention of the foreign exchange markets on the pound, which at one stage plummeted by 17 cents against the dollar in the immediate aftermath of the vote. It is not that the referendum itself came as a surprise. It had been billed for months in advance. It was the result – the vote to leave – which came as a shock as right up until the last minute opinion polls were suggesting the opposite.

For many its was a downright chaotic if not scary night, especially in foreign exchange markets where not only did the pound come under attack, with volumes in sterling trading soaring to nearly unprecedented levels, but even the value of other currencies, including the euro, came under pressure as traders started to consider the ramifications of the British decision.

Dan Marcus, CEO of ParFX, an institutional trading venue, summed up the mood of the night: "As anticipated the E.U. referendum vote proved to be the largest risk event for international currency markets so far this year. Overall, the foreign exchange market expected the U.K. to remain; therefore, the decision to leave caught some market participants by surprise and traders scrambled to reverse their positions, realise hedges and realign their portfolios in the early hours of Friday morning. This triggered significant levels of volatility and pushed sterling to its lowest level in 31 years."

A DRESS REHEARSAL

However, the market and traders were not entirely unprepared. There had been a precedent of sorts when the Swiss National Bank decided out of the blue on January 15, 2015 to undo a four-year old peg to the euro. The announcement caused panic in foreign exchange markets as the Swiss franc soared. One day the euro was worth 1.2 francs. The next it was worth 0.85 francs. Hedge funds rushed to stem their losses and the Swiss stock market collapsed.

"A lot of people learned a lot of lessons from the SNB," said James Watson, Managing Director, London of ADS Securities. "There was a lot of oversight over people's credit limits. There was real control. The market did itself a bit of a favour so there were not many horror stories. There was a definite cautiousness towards trading and hedging positions. I think we can accept that if the SNB had not happened, this would not have been the case." "They knew the Brexit vote was coming towards them. It was telegraphed in advance so people planned. We looked at various scenarios in preparation. SNB was shock and awe but we knew the Brexit vote was coming."

> "The service supported 27% more trades in the 24 hour 'Brexit period' than at any other time since we went live over four years ago."

Alan Schwarz

This didn't mean that there weren't any problems. The technology might have coped for the most part and on a human level, staffing levels were boosted throughout the trading period to ensure smooth operations. But, some clients struggled to get credit as there was a big withdrawal of risk and as Tier 1 banks pulled back from the market the whole profile of liquidity providers, or the key market makers, changed.

"The liquidity provider landscape changed around Brexit," says Watson.

DEALING WITH VOLUMES AND VOLATILITY

Of course, not all had the same experience on the day. Alan Schwarz, CEO of FXSpotStream, says that from a technical side of things, it was very much a normal trading day.

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Risk control during Brexit became paramount

"We, of course, added staff globally to ensure we had more than ample coverage to deal with any issues but we had none. The service performed without incident and all our banks were pricing clients."

Schwarz admits that it "was busier than usual" with his service supporting 27% more trades in the 24-hour "Brexit period" than at any other time since the service went live 4 years ago.

"However," he added, "we experienced no technical issues during an unusually volatile period."

At FastMatch, a major ECN venue, CEO Dmitri Galinov, also reported that "systems operated normally under the increased volumes of quotes and trades." He said the market moved "smoothly and quickly" and clients didn't encounter any off-market trades even though FastMatch did three times its normal average daily volume on Brexit day, totalling about $40 billion.

Technical failures also weren't a problem at FX broker Squared Financial, which has a proprietary and MetaTrader 4 electronic trading platform. CEO Youssef Barakat said both performed well as the company mitigated its risk as much as possible by putting precautions in place. "For example," he states, "we reduced the number of liquidity providers streaming in order to reduce the quantity of quotes coming from the banks which might affect performance. We also increased the quote snap shot time from 50ms to 100ms."

Watson at ADS Securities appears to have had a more revealing experience at least dealing with liquidity providers as the diversity of providers dried up.

He said that in the wake of the SNB shock there was a "massive move away" from centralized credit. As far as liquidity providers were concerned "prime or prime business was dominant" with mid-level brokers and smaller funds squeezed out, especially by algo traders."

As he put it: "There was a big pull back on risk and increased controls from the top."

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"In anticipation of the impact of the referendum result, many platform operators upgraded technology, operations and risk protocols in advance of the vote."


Dan Marcus

Perhaps the most surprising development was the reduction in liquidity provided by Tier 1 banks, which have traditionally been so key in the market. As a result, Watson said, "ECN's and non-banks stepped up to fill the void. "We were leveraging our balance sheet to help others."

Watson reported that although the general market coped with the changes to risk and liquidity, "some people were not hedged the right way and the jungle drums suggest there were some heavy losses."

WHERE WAS THE TRADING FOCUS

Not all companies interviewed were willing to share their statistics on this but obviously trading in sterling, both against the euro and the dollar, came out tops.

Watson reckoned that for the first time, trading in sterling eclipsed trading in the euro and that since Brexit interest in the pound has not really subsided. "We still see lots of liquidity in sterling pairs," he said.

However, the vote also brought a rise in interest elsewhere, with trading in precious metals in general and gold in particular rising as investors sought safe havens in a time of such great uncertainty. Squared Financial's Barakat also reported heavy trading in the DAX, the German stock market, immediately after the result of the referendum was announced.

As far as trading venues were concerned, this was a chance to shine. "This trading period was seen by many as the first major test for brokers, trading platforms and infrastructure operators since the SNB's surprise move to remove its currency peg against the euro," ParFX's Marcus pointed out. And for some, the results couldn't have been better.

ADS's Watson for example, observed that the venues that became important were ECN's and non-banks. Some did massive amounts on Brexit like FastMatch. They were willing to make prices. Elsewhere, there was often some tightening of liquidity in the marketplace.

According to FXSpotStream it too had a record breaking month in June in terms of overall volume traded. Schwarz reported the service supporting the most volume in any month since the company was formed in 2011. "June ADV was up 30% above the ADV supported in May and 42% over June 2015," he says. "Other venues experienced increased activity in the month of June but FXSpotStream to our knowledge recorded the highest year on year increase in volume of the venues that report volume. June continues a trend in which we see our existing clients shift more of their trading to fully disclosed bilateral channels that allows them to understand who is on the other side of a trade both from a risk, credit and a market impact perspective," he said.

Apart from this there were other winners too with Squared Financial's Barakat reporting that FIX API traders "were the most active traders ahead of the GUI."

RELIABILITY OF LIQUIDITY

The provision of liquidity during volatile trading periods is key. Without it, traders are unable to move in and out of positions as and when they want or need to. A reduction in liquidity from Tier 1 banks was certainly an issue during Brexit trading. But, one again, the experience on different platforms and different areas of trading was different.

FXSpotStream's Schwarz reported little difficulty. "All our banks were pricing during the 'Brexit period' and the feedback we received from our clients was that our liquidity providers were in the market actively pricing during a tremendously volatile period."

At Squared Financial which services the professional market, the experience was similar. "Thankfully most of our LP's were providing liquidity in a consistent way. For our professional clients we rely on the top tier banks and all these were pricing even a few minutes from the polls closing when spreads widened extremely on cable (£/$)," CEO Barakat said.

On the performance of Tier 1 banks, ADS's Watson said that although they weren't unreliable "they made trading more difficult."

FastMatch's Galinov agreed. "Bank liquidity providers widened out and some stopped pricing completely. Non-bank liquidity providers used the opportunity and captured major market share. Jump Trading was providing very attractive and consistent liquidity through Brexit and outshone every other liquidity provider on the FastMatch platform."

> "Stop losses were important. Charting was important. Margin control. Everyone changed their margins to be safer."

The functionality of trading platforms appeared not to have been a major issue during Brexit. Both FastMatch and FxSpotStream reported fairly typical behaviour.

"Clients traded in around $1 million notional lots on streaming quotes, which is very typical behaviour," said FastMatch's Galinov.

"The functionality our clients typically use and rely on was the same durng the 'Brexit period'. We did not see a shift in trading patterns between volume done over our streaming or request for streaming offering," added FXSpotStream's Schwarz.

TIGHTENED RISK CONTROLS

Risk control during Brexit became paramount and controlling client exposure became key, especially given fears about lower liquidity and a reduction in credit lines.

Over at broker ADS Securities, Watson noted a rise in the use of good risk tools. "This was quite important to people," he said. "Stop losses were important. Charting was important. Margin control. Everyone changed their margins to be safer."

James Watson

He noted that in the retail market there was a higher level of risk protection. "Everyone was adjusting margins to more acceptable levels. In some cases, there were 10-15% margin cuts to reduce client exposure. There was a lot of good behaviour."

At Squared Financial, they prepared for the event in advance. "As part of the risk mitigation plan we contacted relevant clients explaining the nature of the risk and how the potential lack of or insufficient liquidity might trigger close outs. Clients holding big overnight positions would have been particularly vulnerable. Even with a margin increase applied we were nervous that liquidity could have dried up triggering close outs that were executed on levels where accounts could go into negative balances. Our clients were proactive in unwinding which ultimately protected them. Client protection is in our interest for the long term so we were pleased by the positive reactions and felt this was best execution practice," said CEO Barakat.

FastMatch took similar steps. "FastMatch widened its seatbelt execution tolerances for Brexit so the clients continuously executed in this volatile period," reported Galinov.

"FastMatch widened its seatbelt execution tolerances for Brexit so the clients continuously executed in this volatile period,"

Transparency was also key at FXSpotStream to help ensure liquidity was maintained. "Part of helping clients manage risk is to ensure market participants have access to liquidity in times of stress," said Schwarz. "FXSpotStream took all appropriate measures that resulted in our service being available without any interruption and our banks were able to continuously price their clients. Of course, ours is a fully disclosed bilateral service so banks and clients know at all times who they are trading with and how much volume they are transacting with a given party."


Dmitri Galinov

Trading in gold rose as investors sought safe havens

LESSONS FROM SNB PROVED VITAL

Without the experience of the SNB shock only 15 months before, the performance among electronic trading platforms might have been considerably different.

"Last year some market participants recognized they were unprepared for the unexpected move in euro/Swiss franc that followed the SNB's decision. In anticipation of the impact of the referendum result, many platform operators upgraded and adopted their technology, operations and risk protocols in advance of the (Brexit) vote," said Marcus.

Schwarz agrees stating that, "SNB was completely unexpected and some market participants were unprepared.

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Brexit was a known event although the outcome I would say was unexpected. However, we saw our banks and clients prepare for the worst case scenario and there was plenty of communication in advance of the 'Brexit period' to address all potential outcomes. On our end, we knew that it was going to be a volatile period no matter what the result was and we took all steps possible to prepare for every eventuality."

The lessons that came from the SNB were equally important at Squared Financial and at ADS Securities.

"SNB meant there were more stringent protocols in place for Brexit," said ADS's Watson. Whilst Squared Financial's Barakat notes that: "The SNB was an example in highlighting to underlying clients that if liquidity disappears they will be open to unlimited risk with other market participants. I believe that this is why all the market players reacted efficiently. Volatility did increase but liquidity was always available regardless of the spread concerns. The risk factor was eliminated by the presence of the liquidity."


Youssef Barakat

"For our professional clients we rely on the top tier banks and all these were pricing even a few minutes from the polls closing when spreads widened extremely on cable (£/$),"

EDUCATING FOR THE FUTURE

Platform providers learnt a lot of Brexit, if not least that those that weren't prepared suffered. According to FastMatch, it heard from clients "that there were other platforms that had technical difficulties." "FastMatch gained additional clients by performing well under stressful conditions," states Galinov.

Again at Squared Financial it was a case of keeping clients informed and protected. "We deliver stable technology backed up with liquidity. Our primary concern during the period was protecting the client so for us it would be customer service - we contacted the majority of clients to ensure they reacted – and the team stayed in the office all night to watch the positions," said Barakat.

Keeping clients well informed was also central to FXSpotSream's success.

"We focused on ensuring the service was technically robust to cope with increased volumes and on providing the best possible customer service. FXSpotStream has invested in customer support teams in New York, Europe and Tokyo and will continue to do so as our superior customer service has helped us win business. In preparation for Brexit, we made sure we had full support teams on duty in all three locations and liaised closely with our liquidity providers to ensure continuity of service and liquidity," Schwarz explained.

CONCLUSION

Brexit may not have been smooth running for everyone but it certainly highlighted needs for the future. "It is all about education," according to ADS's Watson. "Concentrating on the education of traders and investors, client appropriateness, the need for discipline, the need to question margins."

Looking ahead, he said, "people are going to desire a higher level of speed and a higher level of risk tools. There will be a requirement for more robust platforms. As volumes go up there is a need for more consistency of pricing. Better risk controls. Clients want to know if you will still be there if they run into problems."