The rise of non-bank market makers

Alan Schwarz, CEO at FXSpotStream, discusses with FX-MM the rise of non-bank market makers in FX and why clients will decide the ones that thrive.

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What has been the driving force behind the rise of the non-bank FX market makers?

There are several factors that account for why we are seeing a rise. They include regulation, the increased cost of capital for banks and the lessened ability for traditional market makers to take principal risk and engage in proprietary trading. It also reflects the fact that there has been a shift away from quantity of flow towards quality of flow among traditional market makers who, in years past, had a greater focus on maximising their volumes. In addition, there has been recent growth in technology providers that have maybe made it easier, cheaper and faster for participants to gain access to tools to facilitate FX market making.

Is it beneficial for the market?

I don't consider non-banks as necessarily being good or bad, just as I don't look at banks being necessarily good or bad. Not all bank market makers are the same and not all non-bank market makers are the same.

In any scenario, whether it is in FX or equities or any other market, I don't think it is helpful to paint participants with the same broad brush. For instance, for some, high-frequency trading has bad connotations, but you have to look below the surface and see how individual participants are behaving.

To what extent do you think the trend will continue?

I think we will continue to see some banks exit some of the market making function, but equally we will see some of the banks increase in that function.

Likewise, you will see some of the non-banks increase or decrease their market share as the ultimate price taker becomes involved in the relationship. That will weed out some of those non-bank market makers who aren't really reliable in their liquidity provision, who aren't really showing tight prices or a depth of market and who aren't there when the market needs them.

The picture will continue to evolve over the next 12 to 24 months: you will see some non-banks exit the market and some non-banks continue to grow and consolidate. I think we just have to continue to watch it.

It is just a natural evolution resulting from regulation, cost of capital, principal trading versus not and technology. I don't view any of this as a bad thing. It is filling a need that the market has and if it is done properly, I think all market participants, banks and non-banks will accept it. From our vantage point, I think the market is accepting that change. That said, not everybody behaves exactly the same, and the FX market is very good at weeding out the good and the bad, I have always believed that.

How has the rise of the non-bank market maker altered the way in which investors access FX liquidity?

It has altered to the extent that if you feel as a client you need to access additional liquidity that you are not seeing, or a different type of liquidity, then you need to find ways to get access to it. That may mean connecting to more APIs, or looking at vendors who happen to have access to that liquidity. The fact that there are a number of vendors who have reduced the cost of doing that makes it easier.

Stepping back, the traditional bank market makers, by a long way, still have the largest market share when it comes to pricing clients. The question a client has to ask is why they need a new liquidity provider – does it give them a better price, is it more reliable, does it give greater depth or offer something not available elsewhere? Some of the answers may be yes, but I don't think a typical client has to become nervous over their access to liquidity if they don't have access to non-bank market making.

How has the shift impacted the ability of market makers to warehouse risk? Has this led to more instability in the FX market?

It does feel like there is more instability in the FX market, but I am not sure we can point the finger of that instability at one source. We could very easily just say it is a sign of the political and economic times, whether it is nervousness over the Chinese economy, Brexit, the Middle East, the political situation in the US or the timing of a Federal Reserve rate hike. We could stop there and not talk about credit and not talk about bank versus non-bank liquidity.

The question is whether the lack of credit, the decrease in traditional banks that are warehousing risk, the nature of non-banks that are not warehousing risk or the improvement in technology that has increased trading speed in FX are exacerbating that instability? There are many factors to consider. In many ways it is a perfect storm and on any given day, at any given moment, one can exacerbate the instability in the market.

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