Changing landscapes:
Electronic trading picks up the pace in commodity markets

*While electronic trading, technology and related infrastructures are now a well-established, if not essential, part of highly-liquid markets such as equities or spot FX, the rate of adoption has been markedly slower in the commodities space. But the past year in particular has seen a notable upturn in demand for electronic trading, from both newer entrants as well as more established venues. Nicola Tavendale and Mike O'Hara of The Realization Group talk to **Ollie Cadman** of Vela, **Jamie Turner** of the London Metal Exchange, **Andrew Polydor** and **David Perkins** of TP ICAP, **Fraser Bell** of BSO and **Bill Fenick** of Interxion about the drivers behind this change.*

The various commodities markets have long been the notable exception to an otherwise global trend of electronification in the financial markets. Even the more liquid markets, such as base and precious metals or oil and gas, continue to be predominantly voice traded - both by phone and in the world's few remaining open outcry trading pits. And yet commodities are also struggling with a now well-established trifecta of challenges: persistent low volatility, declining volumes and global regulatory change. This year, the S&P GSCI commodity index even recorded the worst first-half performance for the commodities markets since 2010. But at the same time, a number of new and established firms in the commodities space have launched innovative solutions in a bid to bring activity back. And as one of the few truly global markets, its distinctive nature demands a more nuanced approach than that taken in other asset classes in order to successfully address the demands of this vital sector.

"The very specific difference between the commodities market and stock or bond markets is that commodities are tied to physical supply."

Fraser Bell, BSO

Must-have hedging

"The very specific difference between the commodities market and stock or bond markets is that commodities are tied to physical supply," **Fraser Bell**, Chief Revenue Officer at BSO, explains. "Prices fluctuate based on physical supply and market demand, whereas equities markets rely on fundamental analysis and market expectations." As a result, one of the main issues facing the commodities space is the unique nature that many of its markets have regarding transportation and storage. According to Bell, this is because a derivative contract, if exercised, implies delivery of the underlying asset. "That can be quite difficult when it comes to commodities because of the incurred delivery uncertainty, leading to harder stock management and higher costs," he adds.

But he also believes that change is on the horizon. BSO in particular has noted increasing levels of investment from the typical, physical commodities client base in telecommunications infrastructure, which Bell says is mainly concentrated on boosting their network capabilities for very stable and fast communications, mostly between mainland Europe and London. “This helps improve liquidity, by providing better data and transparency to the market, particularly regarding stock management and trade matching capabilities.”

However, many markets have traditionally been dominated by physical hedging. In turn, physical hedgers have always favoured engagement with a broker to execute their hedge trades, argues **Jamie Turner,** Head of Sales at London Metal Exchange. “If you look at our base metals market today, around 50% of the open interest is held by physical hedgers across the portfolio,” he adds. Yet while trading was initially conducted by open outcry alone, which the LME still supports, the venue later added telephone trading to the mix, followed by the launch of its electronic trading platform, LMEselect, in 2001. “That has grown to be the main liquidity point for the three months’ contract, but many other parts of the forward curve including, carry trades, all of the third Wednesdays and the other prompt dates are still traded on the telephone, or in the ring,” says Turner. “So, you still have this blend of venues which all contribute towards the LME formation of prices. Physical delivery is still a key part of our market.” In fact, the ability to hedge against a bilateral commercial deal falling through is a critical point about having a physical market, explains Turner. “We’re a ‘market of last resort’, so our futures prices will always be relevant to an actual cash price which was discovered on the LME.”

Value of a hybrid model

A further key driver may also be the increasing globalisation of the commodities markets, particularly over the past 12 to 18 months. And according to **Ollie Cadman**, Head of Business Operations, Vela, that goes hand-in-hand with rising competition and the challenges that such change can bring. “Firms have to be agile in terms of being able to adapt to shifts in liquidity, growth in a particular market or product and be able to manage that on a global scale,” he adds. In addition, he observes that there are a growing number of new venues emerging and in more locations. “We’re working with clients to help them access the growing number of new venues and deploy truly global pricing and trading strategies to systematically hedge and manage risk whilst also taking advantage of the growing number of centrally cleared contracts,” Cadman explains.

> *“We’re working with clients to help them access the growing number of new venues and deploy truly global pricing and trading strategies to systematically hedge and manage risk”*
>
> Ollie Cadman, Vela

Nevertheless, there are still very few products in the commodities space that trade purely electronically, says **David Perkins**, Global Head of Electronic Markets, TP ICAP. He adds: “When you look at energy and commodities, you realise the value of the hybrid voice broker space. So instead, we tend to use our technology more for the benefit of price dissemination and for speedy post-trade affirmation/confirmation, sending trades to the clearing house, etc.” In many ways, TP ICAP is trying to create a technology stack similar to that of an exchange, but one which also has the added benefit of voice broking. This helps to create liquidity and improve price discovery, argues Perkins.

Managing risk

“Yet we do have some businesses where we call it hybrid, when in actual fact if the brokers left the building we would continue to execute trades for probably a day - if not weeks,” Perkins continues. “In the energy commodities space, that’s not the case. If the brokers left the room, that hybrid model would very quickly disappear and all the prices would evaporate on the screens.”

Andrew Polydor, CEO Energy and Commodities, TP ICAP, agrees, adding that while the interdealer broker has had electronic trading screens for nearly 16 years - and they've helped grow the business - it hasn't really got rid of any brokers. "The main reason why the voice broker is still valued is because it's predominantly a physical market," he explains. "It really depends on the definition of what is electronic and pure electronic, because there's still not a lot that trades without some human interaction."

Nonetheless, there is of course a new generation of market participants coming to the fore who are much more open to electronic trading and increasing digitisation in general, says **Bill Fenick**, Vice President of Enterprise, Interxion. He adds: "We've seen this in the fixed income market; it's not requests anymore, it's much more electronic. That's how all of these markets seem to be moving." Yet while the markets may indeed be evolving, Fenick believes they're doing so more cautiously in the commodities market. "It is a different beast than what we've seen for example in derivatives and equity derivatives," he adds. "But participants are now more comfortable with this."

" The main reason why the voice broker is still valued is because [the commodities market] is predominantly a physical market."

Andrew Polydor, TP ICAP

A further key benefit of electronic trading is an increased ability to offset risk, with electronic trading helping to close the gap between price movements in the physical and derivative markets. According to Fenick, data centres can help facilitate this through improved connectivity, not just in terms of latency. Ease of connectivity is important as well to ensure good visibility across all markets, he adds. "Participants are definitely looking to see how they can hedge their risk and so the broader the connectivity is within a data centre, the more they can see other market data and be informed by market pricing, the better it is for them," he explains. "We know the equity markets for example hedge quite heavily, or are informed at least very heavily, by the equity derivatives markets."

On-screen services

Also in terms of data management, Cadman notes that alternative datasets - while they may already have been around for some time - have recently started to gain notable traction. He believes that this then feeds into other key elements such as physical pricing and price discovery, in a bid to gain an edge on market movements etc. "We have certainly seen firms looking at these alternative, or unstructured, datasets and looking for integration there," he adds. "The fact that they are 'unstructured' probably gives some clue about the challenges there, versus exchange data for example."

So while pricing commodities on a global scale continues to be a challenge, this is where firms such as Vela can step in and help bring everything together into a single point and on a single structure, Cadman says. In terms of greater standardisation however, Polydor warns that in these markets, there may simply be too many variables for this to happen. "You can try to standardise trading, but it always leaves you with some residual risk, particularly in these physical markets," he explains. "Nothing really matches perfectly."

And while derivatives trading has also had some success in the past, this is likely to have been fuelled more by the range of trading services available on exchange. "But I think you might see it go the other way with incoming regulations, especially around free trade and post-trade limits on their volumes," warns Polydor. "These markets are not used to that sort of thing. So you might see a little bit of a pullback to more voice trading." Instead, Polydor believes firms need to make available on screen all of those services which tend to be provided by exchanges, such as being able to go straight to clearing at the click of a button.

“ Participants are definitely looking to see how they can hedge their risk and so the broader the connectivity is within a data centre, the more they can see other market data and be informed by market pricing, the better it is for them.”

Bill Fenick, Interxion

Shift to clearing

Additionally, Perkins says that TP ICAP also realises the value of data and is encouraging all of its businesses to capture their data more efficiently. “Generally, the markets do benefit from the transparency and the improved distribution of the hybrid model,” says Perkins. “So it’s in our best interests to try and match a buyer and seller - and that’s hard to do with just voice broking alone.” This drive for greater transparency is also central to many of the new regulations, which are now looming on the new horizon. According to Turner, precious metals is one market where regulatory changes are prompting participants to look for alternative solutions.

“Precious metals have historically been dominated by banks, who price directly to their clients on private dealer-to-client networks and then warehouse their risk on their books,” Turner explains. “But regulatory change is now making some banks start to look at whether they can continue to do this, particularly in light of Basel IV which might make it very inefficient for them from a capital perspective.”

In view of these changes, the World Gold Council and the LME introduced exchange-traded and centrally cleared precious metals products to the London market. LMEprecious, which was launched in July 2017 is so far ‘doing extremely well’, according to Turner, with gold and silver now regularly trading around 5,000-10,000 lots per day. “Regulatory pressures will mean that many participants are now looking to move more towards cleared venues,” he adds. “And more cleared venues normally means more electronic trading.”

“ Regulatory pressures will mean that many participants are now looking to move more towards cleared venues.”

Jamie Turner, LME

Need for market colour

The development of ever faster communication routes between global hubs such as London and Dubai or the Middle East, for example, also helps to form a very precise and transparent price for that commodity, adds Bell. In Q4 2017, Intercontinental Exchange also began selling access to the high-speed network built by Go West, which supports low latency, high frequency trading between Chicago and Tokyo. “Telecommunications and network connectivity is already the game changer in this industry and it will continue to be so going forward,” Bell argues. “Having access to the fastest information basically implies that you have access to the fairest price, with the highest transparency. That in turn lowers cost and enables better hedging mechanisms.”

But for Polydor, it all comes down to how you actually define electronification: “Do I think we will organise marketplaces by using electronic screens? Yes. Do I think they’ll be pinging away without anyone interacting with them? No, I don’t.” Instead, Polydor views electronic trading in commodities as more of a tool to get a price out there, with a new generation of traders that stand, listen and look for the prices. “But once they see the prices, they’ll always pick up the phone to find out more market colour around what is happening with that price,” he adds.

"Voice interaction will never go away, unless it's in a very, very defined short-end part of the market."

Looking ahead

Conversely, Perkins argues that there will indeed be increased electronification in all markets, which will also play to the more standardised products. "Potentially, there might be room for more of these algo non-bank liquidity providing firms to be involved in the more standardised product," he explains. TP ICAP can also offer greater depth of data and has total use of that data, which Perkins argues will also lend itself to increased electronification. "But there's no doubt that, whatever happens, in five years' time we will still have our voice brokers doing solution-based voice broking and adding value to the marketplace," he says.

" There's no doubt that, whatever happens, in five years' time we will still have our voice brokers doing solution-based voice broking and adding value to the marketplace."

David Perkins, TP ICAP

The LME, in turn, has focused on preparing for new rules ushered in under MiFID II in 2018. "There has been a big deployment from LMEselect, LMEsmart and LMEmercury at the LME, and other major exchanges within Europe have also had to deal with the same issues," says Turner. The venue will also be releasing a new market data platform later this year, he adds, which will move the LME more towards multicast market data.

The globalisation of the commodities space is also continuing apace, adds Cadman, with more and more firms wanting access to the growing number of commodities venues offering electronic trading. So for Vela, the aim is to help and support firms to achieve this across the different regions, the different time zones and the different exchanges. "As venues try to attract new market participants and different types of flow to buck the trend on volumes and volatility, this is creating more demand for truly global access to these markets and driving growth in new global trading strategies that capitalise on the growing investment in electronic trading," Cadman concludes.

For more information on the companies mentioned in this article, visit:

www.bsonetwork.com
www.interxion.com
www.lme.com
www.tpicap.com
www.tradevela.com

Financial Markets Insights from The Realization Group, is a series of interviews with thought leaders in financial and capital markets. The purpose of the series is to provide exclusive insights into industry developments, through in-depth conversations with C-level executives and key experts from banks, exchanges, vendors and other firms within the financial markets ecosystem. For more information, please visit **www.financialmarketsinsights.com**

Other topics in the series:

Naturally Intelligent - Embedding operational AI in financial services download
Powering up - Handling high-performance computing to boost alpha and risk management download
The future of trade surveillance - Separating the Spoof from the Truth download
Go with the flow - Are financial firms ready for the data capture challenge? download
Future proofing for FinTech with Network Innovation download
Keeping a watchful eye - Best practices for maintaining trade surveillance download
Digital transformation - Challenge & Opportunity download
AI & Machine learning - Building the future of finance download
MiFID II creates cross-asset revolution across buy & sell side download

The Realization Group is a full service marketing and strategy consultancy specialising in the Financial Services. Our team contains industry practitioners from both the trading and post trade disciplines and we have expertise equally in the on-exchange and OTC trading environments. We apply our comprehensive set of marketing programs and wide-ranging media and business networks to complement the business development requirements of our client organisations.