

Wholesale Physical Markets are Broken

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All is not well in the wholesale markets. Despite the significant growth in the physical precious metals market and the strong outlook for continued demand growth, particularly in Asia, the wholesale physical markets that service that demand are broken. Retail markets for physical precious metals are becoming increasingly efficient and automated, but if you lift the curtain on the wholesale markets, they have struggled to keep up.

Electronic hedging but manual physical trading

Hedging tools such as Loco London or futures are electronic, transparent in terms of price discovery, liquid and efficient, with a high degree of straight-through processing. The physical bullion underlying those markets though remains a manual and costly market to transact. Processes across the wholesale markets from miner to refiner to jeweller to institutional investor are all manual. Physical participants have traditionally relied on phone calls, chat platforms and emails to negotiate prices and complete deals. This remains largely true across the physical commodity space, but it is surprising that for gold, a monetary asset with a long history in the financial sector, it is still the case in 2015.

The gold market is one of the only remaining markets within the banking sector where sales people are dedicated to covering plain vanilla transaction flows on the telephone. In most other asset classes, those flows have been automated so that expensive sales and trading headcounts can focus on higher-valued client requirements such as structured trades or financing.

The manual and high-cost structure of the market is impacting all participants as the industry faces significant issues not least in terms of top-line revenues, but more importantly, in terms of rising costs both from a capital and regulatory perspective. Looking forward, participants are continuing to describe conditions as difficult and the business outlook as uncertain, as physical premiums continue to

be low, investors are fleeing the ETFs, regulatory requirements are growing, capital is being more carefully allocated, and costs and operational risks related to physical trading remain very high.

In some cases, large financial firms are deciding that the easier choice is to exit the physical markets and, in some cases, that also includes the OTC market. The issues faced from a bank's point of view include the rising cost of capital for banks, while non-banks are faced with the high cost of financing – all are concerned about the cost/benefit of the current market versus regulatory and reputational risks.

Increased regulatory scrutiny on the physical precious markets has largely been focused on the KYC/AML risks inherent in physical markets, but it is increasingly clear even in the OTC markets that processes that lack transparent pricing, liquidity or transacted volumes are potential liabilities.

It is clear that regulatory requirements and scrutiny will only increase going forward. A challenging revenue outlook in the gold market, and in particular the physical markets, will be the new normal. Firms that decide they are committed to the sector will have little choice but to address costs and efficiencies. Given the manual processes that dominate the industry, automation is no longer an optional 'nice to have' but an essential requirement to survive, let alone thrive, in an uncertain future.

“ Opaque and manual markets that are difficult to monitor represent a significant potential liability for participating regulated entities. ”

Most market participants would agree that the tide of technology can't be rolled back and that even the conservative bullion markets will succumb to change. The recent LBMA RFI, although very broad in its initial scope, is starting down that path.

The LBMA, as the industry body for the wholesale over-the-counter market for gold and silver, is well positioned to lead the market. Indications are that the LBMA will start by improving transparency in the OTC market by

reporting transacted volumes. The current OTC market benefits from deep liquidity and more transparency should be supportive of developing that liquidity further. It is a market truism that liquidity begets liquidity, so the benefits should be extensive.

There continues to be a discussion about the need for a centrally cleared model to replace the current Loco London OTC model. The capital benefits can be debated, but it is unlikely that market participants will move to a cleared model without a regulatory requirement to do so – that requirement does not currently exist in the gold market.

Outside of transparency and clearing, physical markets are the biggest bottleneck for the sector, and although moving physical assets will remain an expensive requirement, technology could significantly improve efficiencies and profits for all physical participants.

Electronic trading would significantly increase liquidity in the physical markets and that would result in a migration of flows from the OTC market into the physical markets. The biggest deterrents to physical trading are the high transaction costs and the lack of transparency.

The banks are already encouraging their investor accounts to migrate their unallocated positions to allocated, given the more favourable capital treatment for the bank, and this movement should gain broader momentum if physical liquidity and transaction costs approach those of the OTC markets.

The OTC market dwarfs the physical market in terms of size. Any shift in flows from the OTC market to the physical market as a result of a more efficient physical market could have an outsized impact on physical premiums. There are supply constraints in physical markets that do not exist in OTC markets, and given the near-term inelasticity of supply, the way to accommodate higher demand would be higher premiums. This is somewhat counter to conventional thinking that electronic trading reduces margins.

Automation of the physical wholesale markets will also increase the velocity of physical trading, which would have a significant multiplier impact on hedging flows and would drive an increase of volumes in the OTC and futures markets.

The reality is that electronic trading markets improve performance for all participants through the network effect: the more buyers and sellers that connect, the greater the trading opportunity. They also provide participants with the ability to scale and grow their operations with no additional resources.

“Technology leads to near-zero error trading rates and reduces operational risks – lower operational risks reduce banks’ capital requirements.”

The single biggest obstacle to electronic trading in the precious metals wholesale markets is the status quo. The current processes are what participants know and the way they have operated for most of their careers. Similar to the proverbial frog in the pot unaware that the water will soon be boiling, most market participants will say the current market is “not broken” so why is a change needed?

One reality is that senior management and front-line sales and trading will view the impact of electronic trading quite differently. If senior management deems the business line relevant enough to remain in the game, they will need to automate the current transaction process and reduce costs through electronic trading to hit their return equity targets. For sales and trading, the impact can be viewed as a more existential threat, as front-line individuals will need to reinvent themselves as those in equities, rates and FX have done over the last couple of decades. In many ways, it is not a question of should it be electronic or not – the only question is the timing.

Addressing a broken market

Exchange initiatives – new futures contracts

Futures exchanges, both international and regional, have been aggressively introducing new gold contracts. Futures are based on standardised contracts, with a theoretical underlying investment or basket of investments, with a standard lot size and delivery process and location. The counterparty for all transaction is a centrally cleared counterpart (CCP). A CCP makes the onboarding process to access multi-participant liquidity very efficient and there can be clear cross-margin benefits with a clearinghouse.

Many of the initiatives have seen limited market success. The difficulty facing most new futures initiatives is that it is unclear what they are trying to achieve and what the value proposition is to the end users. Is the contract to provide a more efficient hedge with less basis risk or to provide a new delivery mechanism as an alternative to the phone-based physical markets?

From a hedging perspective, a futures contract needs to be liquid with narrow bid/offer spreads and deep liquidity. The CME's Comex meets both requirements and is widely used by traders and hedgers alike. The underlying basis of the contract may not be the same as most hedger's requirements, but as most contracts do not go to delivery, the liquidity benefit may more than mitigate the basis risk. Introducing offshore hedging contracts that look to address the basis risk have so far met with limited success and it's unclear if they were to be successful, what the impact would be on the current Comex liquidity.

Other contracts have tried to focus on physical delivery. This is a difficult objective for a standardised futures contract to address given that the current phone-based physical markets have no standardised product, location, delivery date and lot size – every transaction is customised by client. Many clearing firms have also been rationalising their clearing operations and most have no experience with physical deliveries, making it difficult to access broad segments of the market.

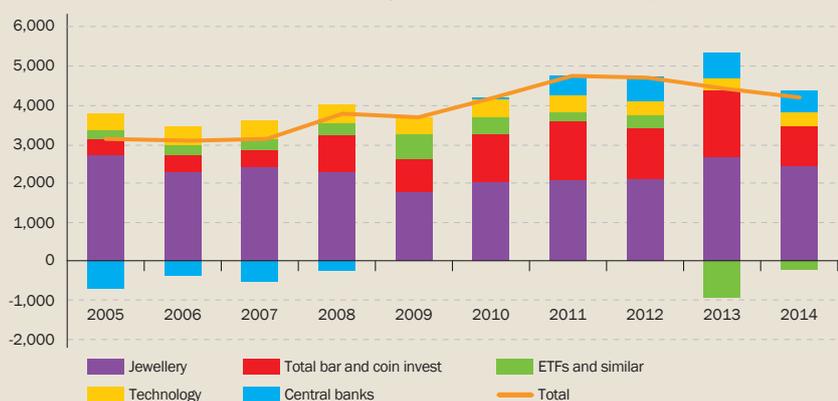
New futures contracts require buy-in from both liquidity takers and providers. The benefits for liquidity takers are typically that futures drive narrower and more competitive pricing. The motivation without a regulatory requirement to move to a centrally cleared model is less clear for liquidity providers as they lose all the pricing power that currently exists with their current bilateral relationships.

Outside the regulated exchange space, new physical platforms are emerging, and they can be broadly characterised as centrally cleared and bilateral models.

Centrally cleared platforms

Centrally cleared platforms are typically closed architecture models offering a limited set of brands and products, one or a few limited specific delivery locations and pre-specified

Chart 1: Global Physical Demand for Gold (tonnes)



Source: Metal Focus, ICE Benchmark Administration, World Gold Council



Pallets of silver bars in deep storage.

settlement dates. Transaction types are limited to outright purchases of gold for allocation or delivery. Users benefit from centralised price discovery for each listed product, and users large and small see the same liquidity. Liquidity providers, similar to an exchange product, lose their pricing power.

The transaction fees of most centralised models remain significantly higher than those of the exchanges. These platforms have had success with the retail sector and unregulated entities, given the ease of transacting a physical product. Their unregulated corporate structure and the high risks that this 'cleared' model introduces from an AML perspective though means that they are likely to see limited traction with regulated financial entities.

Bilaterally cleared platforms

Bilaterally cleared platforms are open architecture models that support any brand and product, any delivery location and any delivery date. They automate all of the workflow and processes that are currently being done over the telephone. All transaction types in the wholesale markets can be supported such as location swaps, allocations and consignments. Pricing is counterparty specific based on bilateral relationships, so liquidity providers maintain their pricing power but automate their processes. Users can benefit by aggregating their suppliers into an electronic framework, making their available liquidity and pricing more competitive and automated. Importantly, the entire workflow from counterparty credit managements, price discovery, client tiering, matching, trade capture and booking, and custodian messaging can be automated. Transaction fees are highly competitive as they need to compete directly with the current voice market. Transactions can remain 'dark' as they are not reported to any other participants outside of those in the transaction, so both user and liquidity providers can maintain the same level of transaction privacy as they have on the telephone. Settlement remains a bilateral process, so no new AML risks are created and the net effect is a significant automation around the end-to-end transaction for both counterparties without changing the underlying settlement and delivery process.

Blockchain

Blockchain has been in the press as the solution to every problem in financial markets. In the last few years, it has gone from being viewed as dark web technology supporting alternative illicit payments and e-money to a trustworthy solution and highly scalable alternative to the current bank clearing and payments platforms, and just about every other banking product. Banks have been scrambling to invest in start-ups for fear of being left behind or disintermediated. The reality is that the blockchain has many persuasive benefits that will eventually be adopted in financial markets, but these changes will not happen quickly. As regulated institutions, banks are very slow to change their core architecture and wholesale adoption will take a few years at best. The precious metals retail sector will lead initiatives in the blockchain as, by definition, its objective is to disintermediate many aspects of the wholesale market.

“In the heady days of the bull market, everybody had resources to throw at technology, and this would be planned and executed with little discussion. Those halcyon days are gone.”

The difficulty faced by all new electronic solutions, whether from an exchange or a platform provider, or even the blockchain, is that this is not an incremental shift in market processes. Migrating from a near 100% manual process in the physical markets to an electronic and automated trading platform is a revolutionary change.

The path for the future approach need not be a 'big bang', all or nothing, straight to a centrally cleared model. Rather, a much simpler migration from telephone to electronic workflow would have a very profound impact on the market and is manageable for all firms large and small. There would be no change in counterparties, clients, settlement process,

product or delivery locations – it would simply require automating the current workflow for a firm's current clients. The net effect will be a much more efficient, lower-cost and scalable operation with full management transparency.

In the heady days of the bull market, everybody had resources to throw at technology, and this would be planned and executed with little discussion. Those halcyon days are gone. For banks that have been traditional liquidity providers in the wholesale markets, 'change the bank' budgets are largely allocated to keeping up with intensifying regulatory requirements, and the declining revenues of the precious metals sector mean that the remaining budgets are being allocated elsewhere. Adding requirements to the technology priority list in a large bank would not likely result in any deliveries for three to five years given the backlog of required work across the bank. For non-banks, from trading houses to regional corporates to refiners, budgeting and managing an expensive IT development is a major undertaking and difficult to justify in the current 'challenging' environment.

As the LBMA plots the industry's future, there is a clear case for a new model that shares a technology stack and offers industry-specific technology tools as a service to all member participants and their clients. High licence fees are a roadblock to adoption and should be eliminated and replaced by low transaction fees so that technology providers and industry participants are aligned with growing volumes, client reach and efficiencies. This effectively updates the concept of Software As A Service (SAAS) to Markets As A Service (MAAS) – hosted and managed solutions for the precious metals industry that enable all participants to automate their operations and scale their capabilities. This will ensure that the physical markets can thrive and drive higher volumes across all OTC markets despite a challenging outlook for the sector and financial markets in general.

With physical demand growing rapidly and the supporting wholesale market constrained in its scalability by a lack of technological innovation, it is more pertinent than ever to move towards an automated infrastructure. With most other asset classes having long moved to an electronic trading, it is high time that precious metals follows suit. Reducing operational risks and increasing efficiency and scalability are key drivers for industry participants as they move towards an otherwise uncertain future for precious metal trading.



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