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Master of Science in Finance

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CFDs and Liquidity Risk Providers:
A Comprehensive Analysis on Hedging Risk
[Capstone Project Summary]

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Executive Summary

Contracts for differences (CFDs) are highly leveraged derivatives that allow investors to speculate on the price movements of assets. However, this area is not as well-regulated as other derivatives. Moreover, trading on margin can increase both gains and losses, making CFDs risky for inexperienced investors. To better understand the risks involved, this paper will look at prudential regulations for brokers based in the European Union and in Australia. We will also discuss the risks and risk management activities of CMC Markets, IG Group, Plus500, XTB, and Plus500. Finally, we will evaluate how the risks transfer from one stakeholder to another and the implications to customers.

Limitations

The data used are from the company and regulatory body websites, annual reports, financial statements, (Basel) disclosures, news articles, and online resources (e.g., CapitalIQ, Refinitiv). However, not all of the information required are readily available. In such cases, the latest or most relevant available data are used.

Regulations

CFDs are over the counter (OTC) derivatives intended to synthetically replicate the performance of the underlying. As such, CFDs, in general, follow the same regulatory requirements as other OTC derivatives. However, due to the increase in popularity of this instrument especially for retail customers, regulators have started to impose additional capital requirements and stricter risk management standards.

Risk Management

CFD brokers face a variety of risks that allows them to facilitate their clients’ trades.

Market risks arise from movements in price, interest rates, and foreign exchange rates. They are actively mitigated by engaging in real-time monitoring and management of exposures, ensuring compliance with their set limits.

Client and counterparty credit risks are from the risks of not getting back what they are due. They are managed by regular monitoring, assessment of creditworthiness, margin tiering, and providing risk management tools to clients, among others.

Liquidity risk is the risk of not having enough funds in a timely manner, resulting to big losses due to the selling of assets at much lower prices. CFD brokers, like other financial institutions, are mandated by law to regularly perform and report the results of liquidity forecasts and stress tests. Moreover, brokers prepare for liquidity problems by ensuring an adequate supply of cash and cash equivalents and by having committed lending facilities.

From a customer's perspective, brokers with poor risk management policies, minimal hedging, low liquidity, minimal regulations, and bad reputation are undesirable. Hence, they would require a lower price to compensate for the extra risk of trading with such a broker. The brokers analyzed in this paper, as well as most of the well-known CFD brokers in the market, claim to have revenue models relying only on the transaction spreads and applicable fees instead of betting against the clients.

CFD Brokers

A Dealing Desk broker is a market maker and provides cheaper and "(theoretically) quicker and more efficient" trades, while a No Dealing Desk broker (NDD) offers market prices and connects the consumer to liquidity providers. To do this, market makers take the best price from top tier banks, liquidity providers, and ECNs, and create a second level price. However, since market makers will act as middlemen between consumers and LPs, there is a potential conflict of interest as an investor's gain would be the broker's loss (and *vice versa*). NDDs, on the other hand, do not have this conflict of interest. Instead, they typically offer higher prices and commission for trades.

Aspect	Dealing Desk	No Dealing Desk
Price	Own price	Market prices
Speed	Quicker	Varies
Revenue	Spread	Spread, Commission
Cons	Conflict of interest	More expensive

Table 1. Comparison between dealing desk and no dealing desk brokers.

NDDs, however, are not completely without conflict of interest. They may not be able to or choose not to (e.g., due to size) transfer trades to liquidity providers. In these cases, NDDs will, through an algorithm, act as a dealing desk and take the opposite trade.[i] Conflicts of interest for both types are demonstrated by the cases presented for CMC Markets (market maker) and XTB (NDD).

While brokers taking the opposite trades profit from the clients' losses, they will consequently take a loss from the clients' gains. Such was the case that led Plus500, a market maker, to shift from a no hedging policy to a targeted hedging policy. Moreover, market makers can be profitable even without betting against their clients. Even though dealing desks do not typically charge commissions, the spread will count towards their revenue since they determine their own prices. This was again demonstrated by Plus500 when the cap on the Swiss francs was introduced. Finally, it is also in the interest of brokers, especially well-known ones, to not cheat their clients to protect their reputation and to retain their customers.

Conclusion

Customers should take note whether a broker they are planning to do business with is a dealing desk or a no dealing desk. However, this alone is not enough to determine the creditworthiness of a broker. In this paper, while three of the brokers are market makers and one is an NDD, we can see that their market risk management policies are similar. The differences lie in the set limits and implementation which are often not publicly available data. Instead, retail clients should look at the regulatory bodies, risk management tools available (for retail clients), order execution policies, and reputation to evaluate the riskiness of a broker. All of these are bound to change at any point. As such, as with trading any other financial instrument, clients should have risk management strategies in place and trade only according to their risk appetite and within their financial capabilities.

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