PLUGIT

Your Reliable Technology Partner

DYNAMIC MARGIN

A Broker’s guide to controlling risk and exposure

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Introduction

How brokers can benefit from incorporating Dynamic Margin into their risk management strategies

Traders love leverage. Brokers crave volume. These are basic facts of life in the retail forex trading industry. While volatility is good for business, too much of a good thing can be dangerous for both sides

In this document, we shall explore how brokers can profit from volatility while reducing risk. With a Dynamic Margin calculation strategy, exposure to volatile assets can be limited without having to disable trading.

Main Takeaways

This guide explains the advantages of incorporating a Dynamic Margin module into a brokerage's technology stack, including:

- Fully automated protection from surges in exposure;
- The ability to offer attractive trading conditions in the face of extreme volatility risk;
- Risk level reduction without having to turn away business;
- Adherence to NOP limits with liquidity providers.

Never has it been more important to stay up to date with technological solutions designed to support brokerage risk management strategies. This document will also address subjects such as:

- Volatility risks and dealing with uncertainty
- Risks of overlooking exposure controls
- Basic exposure management tools and their flaws
- How Dynamic Margin works
- PLUGIT's Dynamic Margin Module

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Volatility Risks and Dealing with Uncertainty

The risks of volatility are widely known. The industry usually puts a positive spin on volatility, but it is important remember that this is not an absolute. Dealing and risk management teams may be well equipped to handle scheduled data releases and most news events, but planning staff rotation around a black swan event is simply not feasible. No-one can foresee which instrument will be most affected by a given event, nor predict which markets will become collateral damage in highly correlated global financial markets.

Human actions have caused the majority of black swan events in recent years, whether by accident or design. A good example is the unexpected decision made by the Swiss National Bank on Thursday January 15th, 2015, a day that many will never forget. The markets were stunned when it abandoned its peg of 1.20 Swiss francs per euro.

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Risks of Overlooking Exposure Controls

Ideally, brokers want their books to be as level as possible and certainly within their risk tolerance boundaries. After all, volatility can harm a broker in the same way as a trader. Here are some of the critical risks retail traders present to brokers:

Excessive NOP

When the trading sentiment of a majority of clients shifts in the same direction, it tends to create a one-sided market, overexposing the broker's book and making the firm vulnerable to gaps and price movements.

Negative P&L

When markets swing violently, the strategic and psychological elements of trading go out the window, and luck plays a big part in whether a trader will be profitable. Regardless of the entry point, any positions with a modest take profit can get hit.

LP Margin Call

When a defined breakout occurs with strong fundamentals to support it, traders can start to believe they have an edge. Greed sets in and clients who

typically risk 5% of their capital will often take full advantage of having 1:500 leverage at their disposal. This leaves the broker open to extreme exposure, on their own book or with their LP.

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Basic Exposure Management Tools & their Flaws

Client behaviour and market volatility are outside the broker's control, but certain steps can reduce risk. There are various methods of regulating exposure to clients. This section explores the most widely available options on platforms such as MT4 and MT5.

Reducing Leverage on Specific Symbols

Reducing leverage on a particular symbol is a quick and easy way to limit the risk a firm is exposed to during volatile times. However, while this does reduce the risk incurred by large clients it comes at the expense of restricting good flow from small clients that pose little risk. Therefore reducing the leverage for all clients at the symbol level comes with its drawbacks and a one size fits all approach is clearly not an optimized way of controlling risk.

Increase Margin Requirements on Larger Accounts

Some brokers choose to set lower leverage on accounts with higher

balances. After all, a trader with a $100,000 account balance and 1:500 leverage can do quite a lot of damage. However, leverage of just 1:100 or even less can be inimical to their trading strategy. Their intention could be to open a mini lot on every pair offered by the broker. These margin requirements would therefore place severe restrictions on the client's strategy and, once again, prevent them from trading.

Net Open Position Limits

While technically limiting exposure, in practice, putting NOP limits on groups or specific symbols is far from ideal. A handful of traders can consume the set limitations, which would mean many other clients cannot trade with those instruments. Not letting clients trade, even on small positions, could cause them to search for another broker.

Switching a Symbol to Close-Only or Disabling

Disabling a symbol or switching it to Close-only is a risk management tool of the last resort if a broker is unable to handle new orders on that particular symbol. This is often done in a variety of circumstances such as temporarily increased LP margins, extreme volatility, lack of liquidity, prohibitively expensive overnight financing, or restrictions on shorting the symbol. It is never ideal to prevent clients trading on a particular symbol, but it is sometimes a must if conditions dictate.

While some of these examples are unlikely to happen, the point to remember is that risk management can come at the cost of user experience and business opportunity loss.

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How Dynamic Margin Works

A poorly managed trading environment inevitably presents significant dangers to a brokerage, and the various basic solutions all have inherent shortcomings. For these reasons, Dynamic Margin has emerged as the choice of many leading companies.

In a nutshell, the purpose of Dynamic Margin is to raise the margin requirements on a trading account as exposure increases.

predefine multiple tiers, each of which will have an exposure allowance and corresponding margin requirements.

Examples of Dynamic Margin

To best understand how Dynamic Margin works, here are several examples of how margin is taken with and without Dynamic Margin applied:

Trading Account Conditions

Account Currency = USD	Balance= 25,000	Equity= 25,000	Leverage= 1:500

Example #1 - Without Dynamic Margin

Providing there is no spread and no commission, without a Dynamic Margin rule, this trading account could get $12.5 million exposure to the market. While this example and the risks associated with it are clear, the next example will demonstrate more clearly the advantages of Dynamic Margin.

Example #2 - With Dynamic Margin

The hypothetical Dynamic Margin structure that will be assigned to this trading account is as follows:

USD Notional Volume	Leverage (margin)
0 - 1 million	1 : 500 (0.2%)
1 - 2 million	1 : 200 (0.5%)
2 - 3 million	1 : 100 (1%)
3 - 5 million	1 : 50 (2%)
5 million +	1 : 25 (4%)

How Dynamic Margin Works

Here are the hypothetical orders the trader will submit:
Position #1: BUY 1,000,000 USD/JPY - This first position falls within the first tier of the Dynamic Margin table, meaning that 0.2% margin is required. The margin taken for this position is $2,000.
Position #2: BUY 1,000,000 USD/JPY - This second position falls within the second tier of the Dynamic Margin table, meaning that 0.5% margin is required. The margin taken for this position is $5,000.
Position #3: BUY 1,000,000 USD/JPY - This third position falls within the third tier of the Dynamic Margin table, meaning that 1% margin is required. The margin taken for this position is $10,000.
Position #4: BUY 400,000 USD/JPY - This fourth position falls within the fourth tier of the Dynamic Margin table, meaning that 2% margin is

required. The margin taken for this position is $8,000.

What the second example highlights is that by employing a Dynamic Margin system, a client with an account balance of $25,000 is able to trade only 3.4 million USD/JPY, as opposed to the 12.5 million in the previous example. While being able to control how much risk this client could pose, the broker is still able to allow them to enjoy relatively high leverage.

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About PLUGIT's Dynamic Margin Module

In 2015, PLUGIT became the industry's first technology provider to launch a Dynamic Margin plugin for MetaTrader 4 and MetaTrader 5. Like the rest of the modules within the YOONIT suite, the Dynamic Margin module has been fine-tuned to meet the needs of brokerages of all sizes and has emerged as the centrepiece of PLUGIT's offering.

Top Features:

- Multi-platform: Works on MetaTrader 4 and MetaTrader 5 platforms.
- Multi-asset: Applies to FX, metals, indices, energy, single-stock CFDs, futures, etc.
- Extendable: Unlimited Dynamic Margin profiles can be created, with each profile supporting unlimited tiers.
- Easy to manage: From a unified interface, brokers can manage multiple MT4 and MT5 trading servers for highly efficient configuration and monitoring.

- Flexible: Dynamic Margin profiles can be assigned to a group, security type, symbol, specific trading account or other options.
- Time-Specific: Implementing margin tiers for Dynamic Margin Profiles based on defined time sessions.
- Transparent: All actions performed by this module can be traced in MetaTrader Journals.
- Understandable: Brokers can set exposure limits according to lots or notional value, according to how clients will understand this feature best.
- Responsive: Settings can be modified on-the-fly to make real-time adjustments during major events.

The Dynamic Margin module allows brokers to design how margin should be calculated and given based on flexible rules. It enables companies to decide whether hedged positions should be netted off against each other, whether a pending order should be counted as exposure, and if there should be a point where exposure is capped, all configured according to in-house policy.

About PLUGIT

PLUGIT is a leading financial technology software provider with an international presence. We boast a proven track record of excellence, having accumulated years of experience in the FX industry. Our core competency is the development of world-class interactive trading system tools and solutions, seamlessly integrated into MT4, MT5 and other platforms.

Put the power of

Dynamic Margin

into your business.

Book a demo!

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