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Unbundled Services:

Credit and Liquidity - Old Problems, New Solutions

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One of the things that makes FX a truly unique market is both its scale and the diversity of the market participants that operate within it. Asset managers, corporates, international banks, regional and mid-tier banks, hedge funds and prop trading firms from all around the world have a real need to access the wholesale FX market.

In many cases though, today, this access occurs via credit intermediaries. This intermediary model places fundamental constraints on the credit available to clients and, subsequently, on the counterparties that they can access. The problem here is essentially that in the current bilateral OTC trading model, credit and liquidity are intertwined – the nature and extent of the latter often constrained by the former. But this doesn't need to be the case. There are market participants willing to provide credit or liquidity independent of one another; the key being a way to "unbundle" these offerings

SPONSORED ACCESS

This unbundling can be achieved by offering a "sponsored access" model, whereby a network of credit facilitators can enable the entire range of market participants to interact on a venue. In this model, the credit facilitators are able to lease out their credit lines and provide clients with market access, without being a trading counterparty. This is achieved through a simplistic legal structure that binds all the participants to the marketplace, as opposed to participants signing traditional three or four way give-up agreements to access the market.

This creates a positive outcome for everyone involved. The credit facilitators are able to monetize credit lines; the clients enjoy wider market access because they have access to a much broader range of counterparties, and the liquidity providers can access order flow without the charge of multiple unused credit lines on their books.

The buy-side faces market access constraints. But it is important to realise that these constraints emanate not from the scarcity of credit, but nature of its bundling with liquidity.

Unbundling these offerings solves for this problem, and in doing so it unlocks credit that wasn't available to clients before. This in turn expands the network of liquidity available for these clients.

FX is a truly unique market both in its scale and the diversity of its market participants

The sponsored access model isn't without its benefits. The traditional approach to credit facilitated FX trading involves clients trading on a give-up credit through designation notices with various different counterparties. This fragments their credit, and in turn their liquidity, which is clearly undesirable.

By contrast, the sponsored access model enables consolidation of credit at the marketplace – as opposed to each counterparty that the client trades with – which enables efficient liquidity access by preventing fragmentation of credit.

And because the credit is centrally managed within the marketplace, risk management can be employed pre-trade enabling certainty of transactions. This also allows credit lines to be utilised much more efficiently.

EXECUTION PERFORMANCE

In addition to market access and broader liquidity, clients are also seeking the ability to improve their execution performance, through alternative execution strategies, and optimization of liquidity pools for each type of risk transfer. On one hand, a credit facilitated marketplace enables the traditional buy-side, access to additional mechanisms to interact with liquidity, such as passive risk offsets. On the other hand, the market operator occupies a unique position to play a more active role in connecting varied types of order flow to an appropriate and tailored quality of service of liquidity. The marketplace then assumes a more meaningful and relevant role, one that is value-additive, than merely being a utility for market participants to interact.

The challenges facing market participants seeking to trade in the wholesale FX market today are significant, but they are solvable. And the industry needs to move towards solutions that deconstruct the services in the value chain and assemble them in a form that allows better outcomes for all participants in the FX marketplace.