Out With The Old, In With The New

Roger McAvoy, Institutional Sales Director – Asia; 360T Trading Networks examines ongoing transparency initiatives in FX trading.

There are many reasons why the call for greater transparency in FX execution, pricing and quote management practices are coming under review. Remarkably, this has accelerated only in the recent past, particularly as a result of public scrutiny and media attention. This centred around prominent court cases in the United States where public pension funds sued their custodians for uncompetitive FX pricing practices going back to 2009, and won (*see Global Custodian*). Since then, the media has regularly reported on a range of issues on FX pricing practice by certain banks, including the widely-used WM/R 4PM fix. This has accelerated the push by asset owners and regulators to demand improvements.

Asset managers are taking a closer look at their "best execution" policies to ensure their own guidelines for FX execution and counterparty management are well defined. Many firms are also taking greater control of FX execution centrally as a way to tighten their own fiduciary duty to their clients, and to reduce reliance on past practices such as "auto FX", the use of standing instructions, chat messaging, and single-bank non-competitive pricing.

Most recently, the Bank of England, along with the HM Treasury and the UK Financial Conduct Authority have laid out a body of work known as the *Fair and Effective Markets Review Final Report,* which covers the FICC market microstructure, structural issues and standards that will be discussed and debated throughout 2015. This will result almost certainly in further changes to FX market "best practices".

The new era of FX trading

Much like the equity markets of recent past, the OTC FX and FX derivative markets are undergoing rapid change in the way liquidity gets sourced, priced and

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distributed. As a result, the buy-side trading desk now faces greater choice in technology, analytics, and liquidity provision than what past practice or past providers have been willing or able to deliver. And with that, comes the need to measure if that choice is the right one, given the pre-trade decision support tools data, analitics, and execution options available. And, before making a change, the buy-side needs to know how the new regime is better, not just different. Access to the right analytics is fundamental to exploring the alternatives.

In equities, there was a convergence of best practice that resulted in greater adoption of algorithmic trading, direct market access (DMA), and a shift from single-broker execution management systems (EMS) into the next generation of solutions. These included greater broker-neutral EMS, OMS and transaction cost analysis (TCA) capabilities. The role financial technology providers have played in electronic trading has expanded greatly over the years. This has resulted in greater buy-side control of execution, and, at the same time also more responsibility on asset managers to make the right choice of solution providers that truly support their interests and those of their clients.

In FX, more asset managers are taking a closer look at the trading technology and the depth and breadth of the data and analytics available from their counterparties and solution providers in order to better understand and control the cost of execution. Some will take it a step further, seeking openly to drive operational alpha and trading alpha to improve performance for their clients. Meanwhile the willingness ofbank counterparties and able to absorb clients' risk as principal is changing, and the shift to an agency-only model will make the use of technology to manage more pools of liquidity even more relevant to the buy-side trader.

The days of "processing" FX trades as "part of the exhaust" of the underlying equity and fixed income exposures, or to reduce operational-risk at the expense of cost management, are changing. It is evident asset managers are taking more control across asset classes and they need a richer set of data to monitor counterparty behaviour and pricing – not only to minimise explicit and implicit trade costs, but also to achieve and document best execution as a part of their fiduciary responsibility to their clients! This is especially important in the OTC FX markets where price formation is mostly bilateral, based on credit, relationship, or the discretion of a sales trader given the client and market information at hand.

Independence and buy-side focus
Asset managers have long-embraced the value of using broker- and bank-neutral technology and relationships to aggregate pricing, execution methods, and the ability to compare transaction costs in a non-conflicted manner to protect their clients' interest. In FX, this is also a major reason why the use of multi-dealer trading technology has gained favour.
In today's ecosystem, asset managers need to think about which technology providers are incentivised to assist the buy-side dealing desk reach below the surface to get a true picture of pricing, price latency, and executable quotes across trade size and tenors, for example. While many service providers may be able to talk about what they can do for G10 currencies, or simple FX Spot, most international asset managers will require access to liquidity across G10, emerging markets, forwards, swaps, and more exotic currencies, including NDFs, and the ability to get auto-pricing on block trades.

Achieving real transparency
In FX, how you look at the cost of execution relative to your eligible liquidity pool is more relevant than looking at the broad market "indicative" rates or synthetically-generated benchmarks of liquidity pools you can't trade into.

Interestingly, in October 2014 TradeTech FX Survey reported that 56% of respondents stated that both equity and fixed income trading costs were as important as FX trading costs. At the same time, 56% also felt that TCA was the most important technology to improve execution in FX. However, while TCA may be clearer cut for equities, there are far greater challenges in attaining a meaningful result in FX given that price formation and benchmarks are less transparent and not as clear cut. To paraphrase, in FX, "a price is not a price is not a price!"

Having access to all of your own data, measuring price and spread according to currency pair and volume, speed, execution method, effect of blocking and netting, and effect of restrictions on fund counterparties are all factors that need to be measured – not just capturing the mid-price at point of execution.

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Finding the right partner to make the strategic shift
The pace of change in the FX markets will continue to accelerate. On the one hand, this will be driven in part by regulators, and on the other, banks will adapt to optimise their capabilities and balance sheets to provide liquidity and their own technology and other services to capture client order flow in a more profitable manner. To navigate in this new world, asset managers need to consider how far and how deep their current technology providers are able and willing to go: engaging with those that deliver transparency and buy-side focus as an independent provider has its benefits.

Bottom line: the FX markets offer their own unique practices relative to equities and fixed income. The buy-side dealing desks that are considering a strategic shift from the practices of the past to new standards of the future, may benefit from taking a closer look at newer technology providers in the asset management space who have a track record for delivering price transparency, facilitating broader and more consistent price competition, and driving open collaboration. Those that do may find themselves better informed with a more powerful lens to navigate the future.

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