How Technology and Data Are Opening the Door to FX Automation

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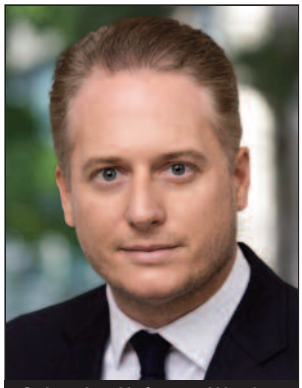
Analysis, Viewpoint


Sebastian Hofmann-Werther

Sebastian Hofmann-Werther, Head of EMEA at 360T, explains how the barriers preventing greater automation for trading non-spot FX products are being overcome, and why buy-side firms could stand to benefit significantly as a result of this.

We would argue that the benefits of automating FX trades are largely self-evident. After all, you only have to take a look at the spot market to see the advantages that it can bring.

On the buy-side, it has allowed firms to streamline their workflows and trade FX far more efficiently, vastly increasing their productivity. And with more of their vanilla trades being executed in a pre-defined manner, staff at these firms have freed up more of their time to focus on orders that are harder to execute.

On the sell-side, while some were initially concerned that automation might undermine their relationships with clients, the reality is that it enabled them to turn their attention and resources to providing these clients with additional services beyond simply providing prices and capturing trades. As a result, rather than undermining their relationships with clients, it actually gave staff at these firms an opportunity to deepen them.

Automation has also brought benefits on the risk management side. By introducing new technological solutions into their workflows, firms have been able to significantly reduce their operational risks, and while we know that fears about Algos "going rogue" tend to grab the headlines, we would argue that human errors have resulted in far more losses than any rules-based automated execution program.

In addition, it provides firms with an exact audit trail of what, where, how and why trades were executed, providing firms with quantifiable answers regarding their best execution process.

All of which begs the question: why then has the automation of non-spot FX products lagged so far behind?

Solving the data problem

According to the latest figures from the Bank for International Settlements' (BIS) triennial FX survey, $999 billion and $3.2 trillion of outright FX forwards and FX swaps, respectively, are traded each day. This is in comparison to the spot market, which the survey put at $1.99 trillion per day.

Given that the combined size of the FX forwards and swaps markets is more than double that of the spot market, one would think that attention would have long ago turned towards ways that these markets could be made more efficient, with automation clearly being one such solution.

And it's not as though it would have been particularly challenging on a technical level to automate the trading of these products. 360T — and, quite frankly, we suspect some of our peers — have been able to facilitate this from a technology point of view for some time now.

The reason why automated execution for FX forwards and swaps has largely not existed until now is because, unlike in the spot market where market data has always been fairly freely accessible, getting an accurate curve has traditionally been very difficult. And without an accurate curve it's impossible to effectively automate trading of these products because firms need to be confident that they are going to be able to execute within a specific market price range.

Fortunately, our Swaps Data Feed (SDF) — which offers full granularity across the curve from O/N out to two years in over 25 pairs, providing data in 400 crosses in G10, EM and NDF currency pairs — is helping us to change this.

As noted before, automation technology was never the real challenge here. 360T's EMS platform offers a rules-based system which enables firms to implement a highly customised, quantifiable and repeatable approach for executing vanilla orders. But it is by combining this technology with the SDF, which is actually integrated into the technology itself, that we're able to truly unlock the potential for automating new parts of the FX market.

How does this work?

If a client using an OMS platform posts trades into 360T's EMS then these trades can be organised based on a set of rules laid out by the user. As an example, a client might decide that if a EUR/USD trade of less than $5m needs to be traded during New York hours in one particular fund's name then it should be automatically executed, but only if they get prices from 75% of their bank basket in a time frame of less than one second and a spread that is within a certain threshold from the market midpoint determined by the SDF.

The lessons of automation

Much as it once did in the spot FX market, what this does is enable firms to effectively automate "nuisance trades" so that they can spend their time focused on more important parts of their business where they can add the most value.

Crucially though, this automation also lends itself to proving best execution when trading FX forwards and swaps. It used to be that when trading these products, firms would simply request three quotes from their counterparties and then just trade on the best of those three prices. Today, this often isn't enough to be considered best execution.

Instead, firms are expected to check the prices coming in against market data sources, but the problem is that the sources that they're currently referencing to validate their trades typically only show indicative rates. This is again where the market data piece is crucial.

By having an automated execution workflow which is integrated with and utilises an independent, highly accurate source of market data, firms are able to effectively demonstrate best execution.

Of course, the FX forwards and swaps markets aren't going to start looking or trading like the spot market, but there are lessons to be learnt from the technological changes that we've seen in that product segment over the years.

One of those lessons is that automation has become increasingly prevalent precisely because it streamlines workflow management processes, reduces operational risk and offers validated outcomes for best execution purposes.

The fact is, buy-side firms are not adding value to their investors through the execution of vanilla trades. Therefore, it's clearly in their interests to simply automate those trades and concentrate on the areas where they are actually differentiating their offering and adding value.

The case for greater automation in FX is clear, and now at last both the technology and the data is available to enable it.

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