The evolution of FX electronic trading on the buy-side and factors driving change

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REVOLUTION OR EVOLUTION?

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 only accelerated in the last few years, as a result of public scrutiny and media attention on uncompetitive FX pricing practices that has affected institutional investors and others globally.

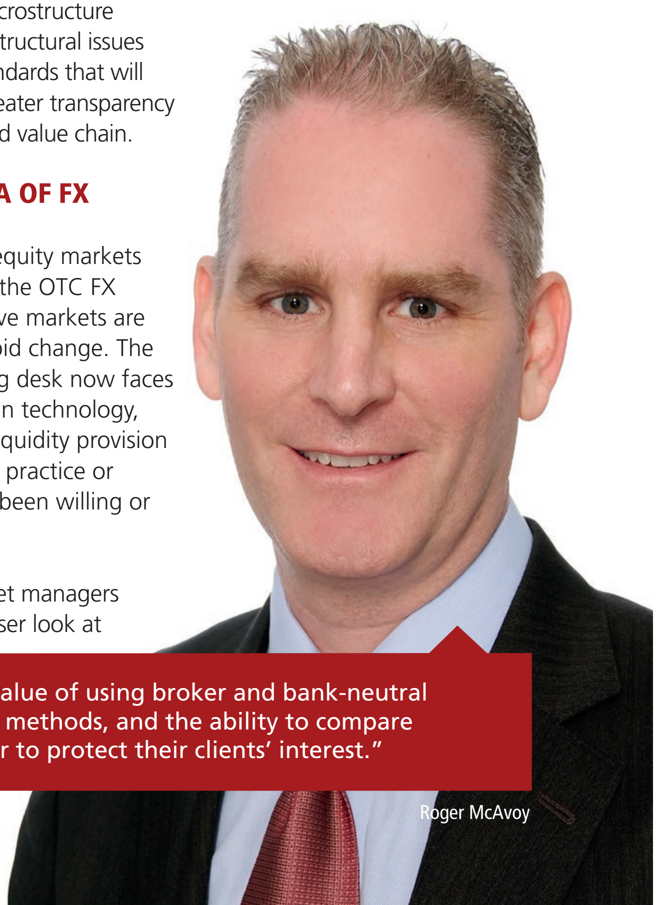
As a result, asset managers are taking a closer look at their "best execution" policies to ensure their own guidelines for FX execution and counterparty management are well defined. Many of these firms are also taking greater control of FX execution centrally as a way to tighten their own fiduciary duty to their clients, improve risk management, 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, has added to the debate with The Fair and Effective Markets Review Final Report, which covers the FICC market microstructure and highlights structural issues and current standards that will benefit from greater transparency and an improved value chain.

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. The buy-side trading desk now faces greater choice in technology, analytics, and liquidity provision than what past practice or providers have been willing or able to deliver.

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 in order to better understand and control the cost of execution. Some will take it a step further, seeking openly to drive operational- and trading-alpha to improve performance for their clients and to establish new consistent workflow. Many institutions have realized that equity-like TCA is not enough in an OTC market and that 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 is no longer tenable. Many would benefit from working with a consultative partner to help define the future and navigate possibilities that were previously unavailable.



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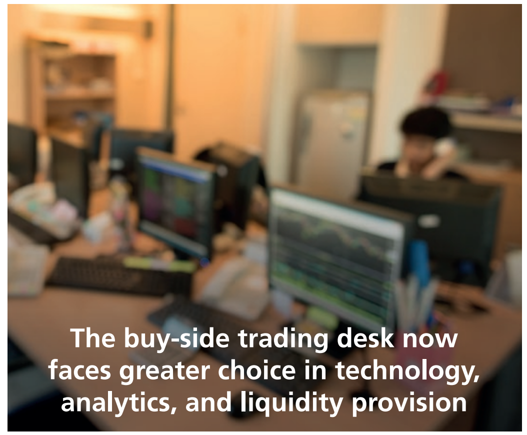
INDEPENDENCE AND BUY-SIDE FOCUS

Asset managers have long-embraced the value of using broker and bank-neutral technology to aggregate pricing, execution methods, and the ability to compare transaction costs in a non-conflicted manner to protect their clients' interest. In FX, as in equities, this is also a major reason why the use of multi-dealer trading technology has gained favor.



The buy-side trading desk now faces greater choice in technology, analytics, and liquidity provision

In today's ecosystem, the buy-side needs to think about the motivations of technology providers and decide which are best incentivized to assist them reach below the surface to get a true picture of pricing, price latency, and executable quotes across trade size and tenors, for example. Most international asset managers will require access to smarter data and analytics, greater liquidity and insight across a range of FX financial products, and a partner who will help drive for more favorable pricing, automation, and workflow capabilities.

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. To paraphrase, "In FX, a price is not a price, is not a price."

Interestingly, an 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.

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.

FINDING THE RIGHT PARTNER TO MAKE THE STRATEGIC SHIFT

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.