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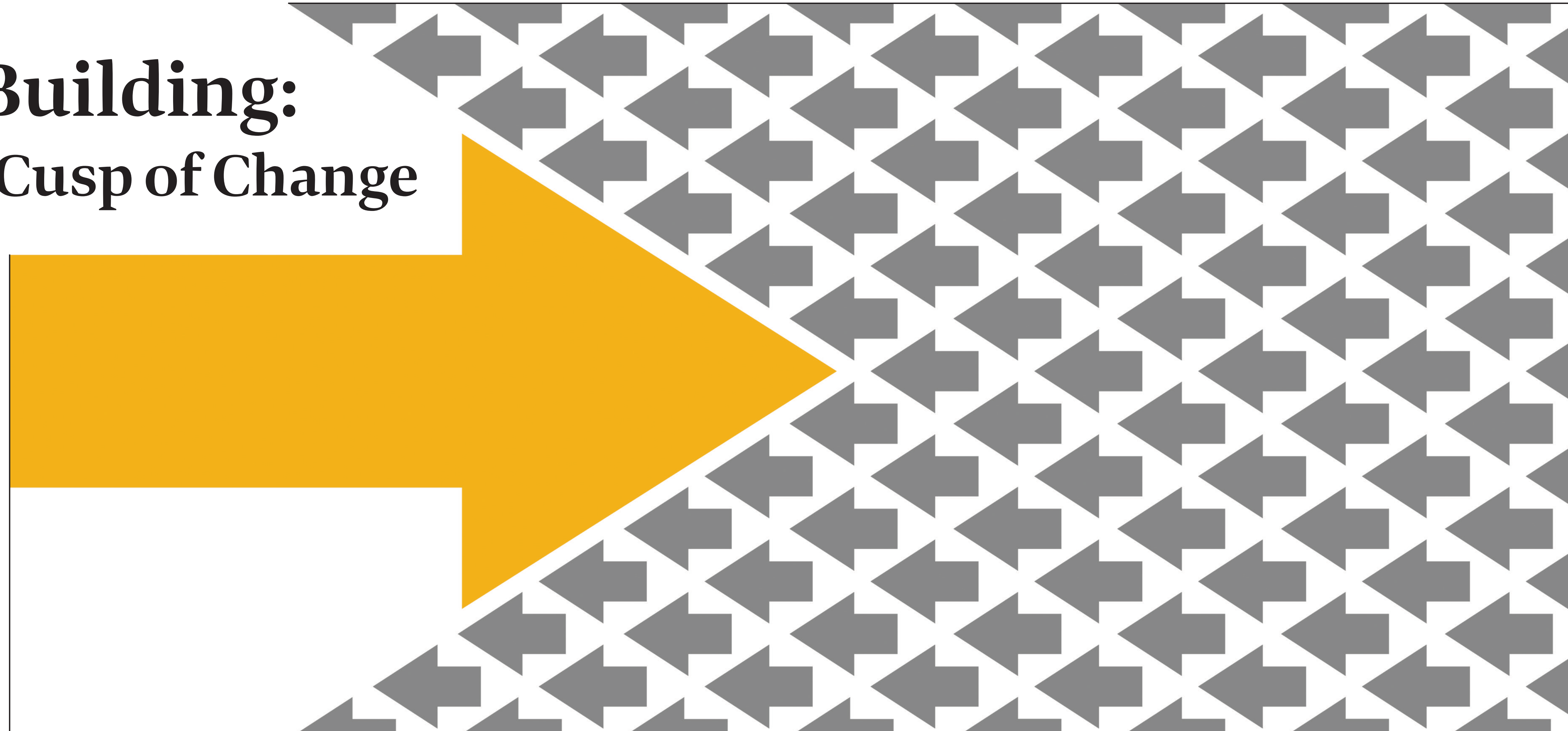
Momentum Building:

FX Swaps on the Cusp of Change



Is the last bastion of the "traditional" FX market about to be overrun? Talking to market participants and technology providers, Colin Lambert is starting to think that market structure change in FX swaps is, finally, upon us

In terms of false starts, the restructuring of the FX swaps market has, over the past decade and a half, had more than the 100 metre sprint at the summer Olympics. Probably the first was in 1997 when the FX industry had a "we have seen the future" moment with the launch of what was Reuters D2-2 for forwards, or Matching as has long been known. Rumours abounded of challengers to the platform, not least from its close spot rival EBS, but the reality is that until very recently Matching for Forwards has had the market to itself.

The banks advanced the automation of the product by including forwards on their single dealer platforms, initially as an RFQ but then as a stream; the multi-dealer RFS platforms followed suit and then? Not a lot. "I think the industry has lagged behind on building out FX swaps infrastructure because the clients were generally happy with what they had," suggests the head of FX forwards trading at a bank in London. "Even more than spot clients tended to look at swaps as an administration trade and as long as the price was tight, they could electronically trade and were happy.

"It is only in the last couple of years when other factors came into play that the banks started looking at the issue again," the FX forwards head continues. "There is a fear that the market structure change will bring more competition to the space with non-bank firms able to play, so the banks have, finally perhaps, become more engaged on the subject of forwards market structure."

The e-FX head at a bank in London believes any change has been thwarted by forwards dropping further down the task list the more challenges emerged elsewhere. "Most banks could have driven change in forwards eight to 10 years ago had they been more open on credit allocation and not had to deal with unexpected challenges elsewhere in the business," the e-FX head argues. "Our business certainly looked at several FX swaps initiatives post Dodd-Frank but then we found – as many did – that our spot business was haemorrhaging cash and was losing market share thanks to others being better at pricing and risk managing. When that happens, the only option is to maintain the status quo in the forwards and throw everything you have at the spot business."

The head of forwards at the bank in London also believes the ambiguous nature of the FX swaps business, specifically where it sat in the broader business, hampered development ambitions, noting, "It's hard enough getting buy in for change in one business, but when the FX business is trying to drive it and bring the interest rates silo along for the ride – for that is where FX swaps sits in many institutions – you're just making the challenge twice as hard."

There were three other factors at play in the resistance to change, the inability to reach consensus on what the market structure should look like – as one interviewee for this story points out, FX clearing is not exactly a new concept – and forward traders' liking for trading at mid-market. "The voice brokers did – do – a really good job of selling their ability to bring buyers and sellers together," says the FX forwards head. "Traders on the desk just got used to the fact that the bookies were often executing at mid and in those circumstances why change?"

The third factor is ongoing, the very flat interest rate environment in the world today. "There's still money to be made in these markets but it's a fraction of what it was 10, 20 and 30 years ago," explains the FX forwards head. "That is pushing more banks towards the 'broker' model where they just facilitate customer business.

"I am a little concerned as to what happens when interest rate volatility returns – as it will someday," the head adds in what could be a warning to the market. "We had the 'taper tantrum' in 2013 which some dealers found tricky to handle, and when it comes to seeing things for the first time, in 2015-17 we had traders on the desk experiencing their first ever Fed hike. There is a whole generation of forwards and interest rate traders coming through who have no concept of how busy it can get when we get divergent interest rate paths."

Whilst all the aforementioned challenges existed and played a part in the slow change in the FX swaps market structure, there was one issue over-riding all – solving the credit bottleneck. "We have spent a lot of time talking to clients over the years about changing how the credit check is done and we often get pushback because they are concerned about collateral management, which plays such a big role in credit availability for short term funding requirements," says Paul Clarke head of FX trading venues at Refinitiv. "A lot of our clients are using Matching for Forwards to manage their short end funding requirements and rolls, so they need to be able to continue to meet that need as the product evolves."

While Gavin Wells, head of FX swaps strategy at Deutsche Borse's 360TGTX platform, believes the FX swaps market is at a

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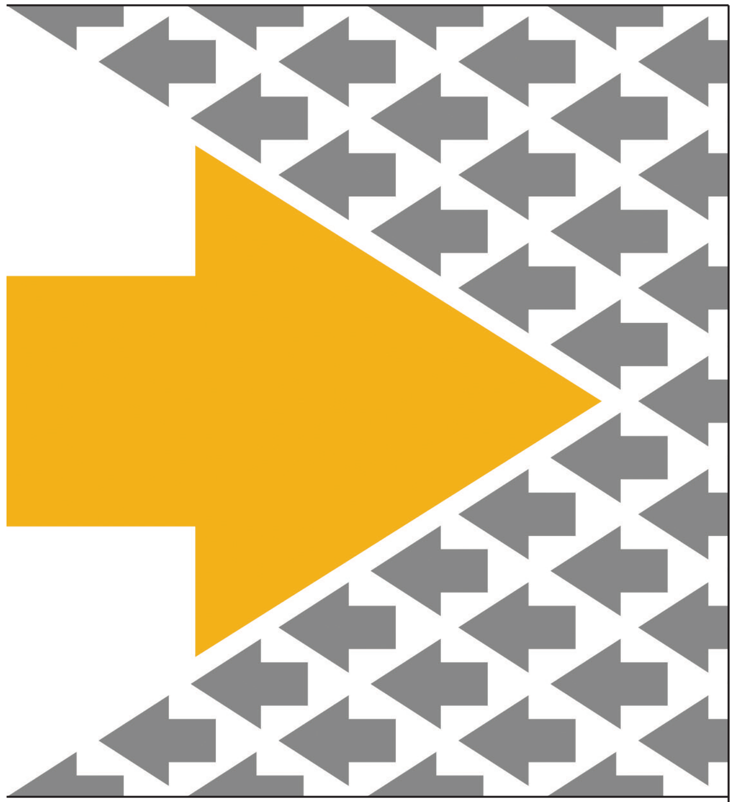

turning point, he acknowledges that overcoming the credit hurdle remains a substantial challenge for some. "Fully-automated trading in FX swaps is missing because of the manual credit checking that has to take place," he observes. "You can't really move to API trading when there is a manual credit check, which is why we built Mid-Match."

Changing Moods

The problems are clear, therefore, but whereas three-to-five years ago few were looking at solutions, now there are a plethora of firms seeking to clear the bottleneck created by credit and post-trade processes generally. From CME Group's FX Link which seeks to break down the barriers between the OTC and futures markets through a basis spread trade, through countless technology solutions seeking to optimise collateral, credit and capital, to new offerings such as the New Change FX beta indices, the industry has more choice than ever before. More importantly, however, there is a mood for change.

"Working with voice brokers became very hard during the lockdown and that has made banks think more about their forwards business," explains the head of forwards at a bank in London. "The result is they want it to become more electronic, but this time the impetus is coming from above, where it once wasn't.

"Traders are also being made even more aware of the cost of them occupying the seat," the forwards head continues. "As regulation pushes into the FX swaps market they are faced with no choice but to embrace the change. Costs suddenly matter a lot more than they used to for these traders and while they are more obsessed than ever with making money, there seems a greater awareness that lower cost bases can reduce the ultimate number they need to make to be seen to be successful."

Automation is also being embraced. "The e-trading teams, who typically have passed their positions to the voice desk, now want to auto-hedge their exposures to gain efficiencies and because they are seeing more of their clients electronically trade forwards," says Clarke. "We are also seeing clients become more interested in becoming market makers by posting interest – that is one reason we launched our API for Forwards Matching earlier this year. It's not just about the short end now either, there is a lot of interest to price and execute along the curve."

Reinforcing the point, Clarke says that Refinitiv is planning the roll out of what is effectively an Excel plug in that will allow manual traders to interact more easily on the platform. "If a bank hasn't got the infrastructure or doesn't want to spend the technology budget coding to our API, they can use this Excel add-on to publish their prices or curves and execute their trades more effectively," he explains.

Another important factor in the evolution of the forwards market structure is – and again this has been a long time coming – competition. "360T launching its swaps product has been good for the industry, for while we may not want fragmentation, we don't want an effective monopoly," says the head of e-FX at the bank in London."

Unsurprisingly, Wells agrees. "We believe the market should be offered choice and what's missing in terms of choice in FX swaps has been price transparency," he says. "It's not only about trading, it is also about providing better pricing for many other areas including, for example the middle office doing rate reasonability checks."

Wells also believes another factor is at play in FX swaps at this time – the entrance of new players to the market. "The BIS and FX Committee surveys have signalled the growth in FX swaps, not just as a notional amount but also as a share of FX trading overall," he says. "This seems out of line with existing market participants simply wanting to do more FX. To me it supports the notion of new participants in FX swaps, with new motivations to trade.

"These players are there because of things like the liquidity coverage ratio, where you need to hedge all your outgoings for the next 30 days, and other capital requirements that have driven a need for funding, and this is becoming a more common theme – the desire to use FX swaps for funding," he continues. "Funding and liquidity pressures seem evident by the continued use of FX swap lines between central banks – the question now is whether the FX swap market can provide the funding function that came from these."

> This is probably the last shot for clearing to present itself as a viable alternative to some sort of automated bilateral credit solution. We do believe the change will occur but it's far from guaranteed

Gavin Wells

Front Office Solutions...

Impending regulatory pressure – and it remains significant that FX swaps remain outside of regulations in some jurisdictions – will force a degree of change, but to get the full experience, traders, both electronic and voice, have, as Clarke notes, to be brought along. "We have to be thoughtful about how we change the model and, for example, manage credit and the trading workflow," he says. "We know the market is going to evolve and we want to ensure that all our clients can benefit –we have 300-plus clients on Matching for Forwards and they should all benefit from being able to trade with the rest of the community."

In terms of what is actually being done, the main focus seems to be on supporting the existing experience of traditional traders whilst also enabling e-traders to execute effectively with the broad set of participants on the venue. Refinitiv has an "upping the quantity" function which allows two participants to trade initially, and then communicate with each other to increase the size of the trade. This is done in the post-trade environment and Clarke says the functionality has proved "very popular".

At 360T, Wells also stresses the importance of engaging with all sides of the market, reiterating the platform's desire to provide greater price transparency. Noting that it is "odd" that in the biggest segment of the biggest market in the world there is minimal price transparency, Wells argues that once that transparency is delivered best execution can be enabled both manually and via API, something that plays to current and impending regulation.

"Our swap data feed has over 20 banks, pricing in more than 48 currency pairs in over 60 tenors," he says. "That means lots of prices that are – importantly – clean of skew for credit and that are delivered by an independent third party. If you have a mid-price, people start looking to trade on it, which is why we built Mid-Match. Clients can see mid-market through the Swaps Data Feed and then post interest in a dark environment to exchange risk at that level.

"This brings players together but that doesn't work effectively without a better credit model," Wells continues. "The soft credit model has its place but, again, we believe there has to be choice – Mid-Match automates the credit checking process – you cannot stop a deal for credit purposes, so there is certainty of trade."

Fungibility also plays a role in the new solutions, with CME's FX Link pioneering, although it is notable that not everyone views it positively, with one senior forwards trader observing that there is still an underlying lack of liquidity holding back broader adoption. "It's an elegant solution, but maybe too elegant," the trader argues. "I still think there needs to be more flexibility – this is not just about capital and credit charges, the bottom line for any trading venue is it has to offer deep enough liquidity."

The head of forwards at the bank in London acknowledges that futures are not the largest part of the FX market, but feels they are important, especially if the fungibility can be built out further. "I think CME is missing one important piece of the puzzle – and that is direct access to an OTC forwards platform to help it build liquidity. It owns EBS so the opportunity is there if it can grasp it. FX Link is still likely to play an important part in the evolution of FX swaps if it can fill that gap."

360T's Wells is bullish over the prospects for a blended pool of liquidity embracing OTC and futures. "When you bring those two pools together you create opportunities," he says. "We have seen how popular swap algos have become and if we succeed in building these fungible pools of liquidity then I think you will see streaming EFPs – and that provides the global market with another source of funding, hedging and alpha generation."

Gil Mandelzis

> We are going to see a growth in clearing, that is a fundamental step... but we are also going to see solutions outside that space such as compression and novation

...And Back

It is a testament to the impact of regulation that the biggest driver of change in the FX swaps market is unlikely to come from principals or intermediaries in the market. With capital, credit and collateral management dominating the agenda the fintech world is driving a lot of change, and seeking to push even further in the search for efficiencies. "The issue is more complex than just credit limitations," observes Gil Mandelzis, founder and CEO of Capitolis. "It could be that a firm is running out of appetite for a certain counterparty due to risk-weighted asset reasons, especially if that counterparty is not highly rated and comes with a much higher weighting.

"Financial resource optimisation has become a major issue, but if, for example, you liken it to the e-commerce evolution, then we are in the 1990s. There is little refinement or granularity, and the appropriate tools to deal with this complexity are not available on an industry wide basis," he continues. "That is what Capitolis offers, a more customised approach that recognises that different market participants have different motivations and limitations

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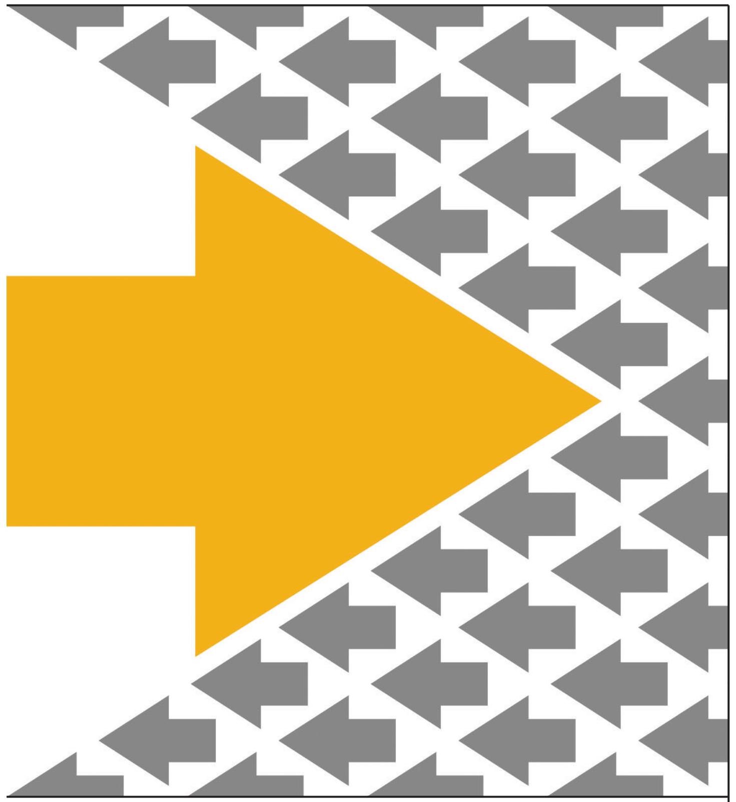

regarding their trading, but it is still very early days. Senior management at the banks understand the problem, but at the trading desk level that understanding is only now starting to have an impact."

Mandelzis believes that interest in optimisation is going to spread beyond the top 10-15 players currently engaged on the issue. "We are going to see growth in clearing, that is a fundamental step towards solving the issue, but we are also going to see solutions outside of that space such as compression and novation," he says. "Three years ago people were saying I don't need to compress in FX – that is changing."

Earlier this year a Bank for International Settlements' paper found evidence that G-SIB requirements were prompting several larger banks to pull back from the FX swaps market at month and quarter ends, thus signalling that what was once just a year-end problem has now multiplied. Banks seeking to reduce the G-SIB rating through lower forward exposures saw spreads widen at these crucial junctures in firms' funding cycles, the paper found.

Andrew Williams, CEO of compression and optimisation services provider Quantile, points out that compression works well for reducing G-SIB scores and believes the spillover from interest rate markets will continue, making the service even more valuable to FX swaps desks.

"Business managers are starting to look at both cleared and uncleared exposures together," he says. "Whether it be the FX or rates business, they are focused on their total funding cost regardless of where the trades reside, so while our optimisation service started looking at uncleared margin, increasingly it's being used to incorporate cleared positions as well."

Williams believes that there will continue to be greater interaction between trading and optimisation desks within banks. "In addition to the XVA desks, the optimisation desks also look at firmwide exposures to try and make the business as a whole more capital efficient, which is where we can help. Traders should be free to focus on pricing to clients and accessing liquidity, on multiple venues using multiple products. If Quantile can efficiently rebalance risk across these channels and products, there is a feedback loop that leads back to the trader making tighter prices to clients."

The Nine Ton Gorilla

"You can forget the saying about the 900-pound Gorilla in the room," says the head of forwards trading at the bank in London. "We have an absolute monster sitting there and it's got a clearing tag around its neck. There are those who feel clearing is a panacea and others who are less sure – all I can say is that if clearing does eventually emerge as a major part of the FX swaps market then we would have discussed it to death internally and it will be there because it works."

At face value the argument for clearing seems strong – a centralised liquidity pool without credit restrictions – but if that is the case, why is it taking so long for the market to embrace it? Dodd-Frank was seen as a driver but exempted FX, the CFTC in 2014 looked set to mandate FX clearing but pulled back and then just a year later Europe looked like it was going to take the lead, but again nothing has happened. "I think there were cost issues," says a source in the clearing world. "Few firms were going to spend valuable resource on building the framework required for clearing, but as UMR gets closer, that mood is changing. Frankly it just wasn't important enough for most banks and, if you ask them now, they would still prefer not to be heading that way."


Andy Williams

SA-CCR provides a significant incentive for clearing. We need to clear in an optimised fashion to increase netting and decrease risk fragmentation across multiple netting sets

The reluctance to embrace change is partly, some argue, because clearing will ramp up competition levels in the forwards market and drive something similar to what was seen in spot markets with the entry of non-bank market makers. "Getting prime brokers onto the OTC trading platforms would be a good start, it could provide additional liquidity and interest," says a senior manager at a platform. "There will be resistance from banks, though, and I wonder how many platforms are really willing to poke that bear at this time when competition is high and volumes in spot are not exactly growing."

We know the market is going to evolve and we want to ensure that all our clients can benefit from being able to trade with the rest of the community


Paul Clarke

It could be argued, of course, that with spot volumes largely static platforms should indeed be looking at not only building forwards platforms but actively seeking new LPs to power them, but as a senior trader at a major asset manager points out, "We're perfectly happy with our pricing in forwards. We can put banks in competition, spreads are tight – why do we need to go elsewhere?"

There is also the factor that the really big issue being solved for in FX swaps does not, to a large degree, involve the buy side – it is very much about automating and bringing efficiency to the dealer-to-dealer market that makes up such a large proportion of trading. That said, if the core market structure is enhanced, inevitably buy side clients will want to see the benefits of any change.

Whichever way one looks at it, credit remains a bottleneck, however, as 360T's Wells observes, "Automated credit is pretty good but it's not centralised credit – that only happens in an exchange or central counterparty environment."

Wells believes that the changing rules are driving FX into a more regulated environment, but accepts it is still very slow to change. "The change to the SA-CCR risk model next year is really beneficial for clearing and it ties in with the tail end of the capital regulations in UMR, which also happen next year," he says. "SA-CCR brings netting benefits and could lead to a re-shaping of market infrastructure."

Intriguingly, however, Wells also warns, "This is probably the last shot for clearing to present itself as a viable alternative to some sort of automated bilateral credit solution. We do believe that the change will occur but it's far from guaranteed."

Capitolis' Mandelzis sees clearing as the "central limit order book of optimisation", which has a role to play going forward, noting, "SA-CCR lends itself to optimisation where participants can rebalance their exposure, not only between their uncleared counterparties, but also move some of their risk into the clearing house, so there are significant capital benefits, which could lead to the clearing of more deliverable FX."

As long as the OTC market dominates, however, Mandelzis stresses the need to alleviate capital and credit pressures more generally. "This is the number one bottleneck in FX markets," he says. "Break that bottleneck and you can unleash tremendous growth because there is a lot of pent-up demand existing today. Any time banks don't want to win business due to regulations like G-SIB you have a fundamental problem – one that needs to be solved. We can help solve those balance sheet problems and help the industry grow by offering a flexible, granular solution."

Williams acknowledges the concern that margin requirements could get out of hand as FX clearing grows if it is not managed in an appropriate manner, but believes the argument for clearing in FX is becoming more compelling. "Uncleared compression is typically harder than cleared compression as you need to consider the counterparty risk and various financial agreements between banks," he observes. "When compressing at a CCP, it's a different and more efficient process, so if there is more clearing of FX over time it will benefit compression activity and free up more capital for the business."

"The rates business has generally been front and centre from a compression perspective but it's fair to say that all businesses want to drive efficiency and most are assessed on return on capital, not just outright P&L," he continues. "This means the incentives to optimise the use of financial resources, such as capital and funding, in each individual business is becoming increasingly important. Compression and counterparty risk rebalancing both have a significant part to play in FX going forward, and more clearing will help drive that."

"SA-CCR provides another significant incentive for clearing," he adds. "We need to clear in an optimised fashion to increase netting and decrease risk fragmentation across multiple netting sets. This optimised approach will help to realise the material benefits of clearing whilst managing the total margin and capital requirements across the portfolio."

It is unlikely that all FX swaps will trade in an automated fashion, or be cleared, there will always be bespoke transactions with clients and different demands from the sell side hedging fraternity. There is a real sense, however, that genuine change is coming, both in terms of automated trading, optimisation and clearing. From this a new, more modern, FX swaps market is likely to emerge which is in itself important. For as 360T's Wells points out, "People have been discussing this for a long time, which is right because FX provides the oxygen for the global economy. Now, however, more than just enabling cross border trading, the FX swaps market is seen as a primary source of funding which means it has to modernise. It needs more automated credit checking than it currently has; clearing for those counterparties that require it to ease their regulatory burden; and deeper liquidity through a fungible cash and futures market.

"A homogenised FX swaps market would offer a really viable and richer pool of funding to a market that really needs more capital than is currently available if it is to provide the resiliency and stability that both participants and regulators want."