The inexorable rise of FX Algos

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Arguably one of the most consistent trends within the FX industry in recent years has been the growing adoption of execution algos amongst market participants. This has been driven by a number of different factors. For instance, in a market where liquidity is heavily fragmented, such as FX, algos can be used to aggregate order book data across various different liquidity pools, chop orders up into smaller pieces and then execute them across these liquidity pools. This can help to achieve better pricing and reduce market impact, particularly when executing larger orders.

Another benefit is that, much like automated trading more broadly, algos help to drive efficiencies while also reducing the operational risks that are inherent in any manual process on the trading desk.

And then there is the fact that the algos themselves have steadily improved over the years, as well as become much more widely available. FX algos have evolved from tools designed to slice up orders in a fairly basic fashion and feed them through the market to more sophisticated and adaptive products that can react in real-time to changing market conditions. The increased availability of high-quality FX market data has further improved the algos on offer.

The sharp uptick in the use of transaction cost analysis (TCA), particularly amongst buy-side firms, is also a reason why FX algos have become more popular. These firms have become more focused on measuring execution quality, signalling risk, optimising liquidity pools and market impact and this increasing sophistication around execution has in many instances led firms to introduce algos into their toolkit as an alternative means of executing their FX trades.

ADAPTING TO VOLATILITY

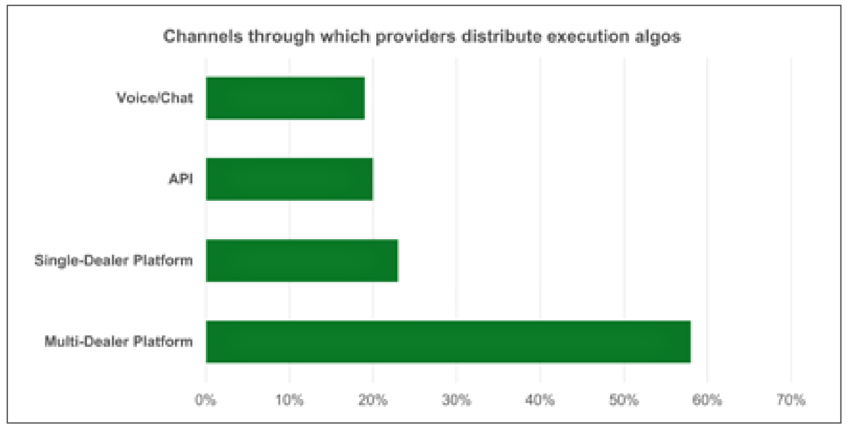
But while these broader trends have been driving algo adoption in the long-term, the pandemic has proven to be an additional driver in the short-term. In March 2020 as volatility surged many market participants turned to algos as risk transfer spreads widened out dramatically, especially for larger orders. Passive algos allowed users to manage their orders over time at prices inside the bid-ask spreads and keep their market impact to a minimum. In addition, because algos inherently provide a clear electronic audit trail of all trading activity in some cases there were compliance benefits to using these tools as companies shifted to a work-from-home environment.

The increased adoption of FX algos in 2020 was reflected across 360T, as the volume of trades executed using these tools increased by 50% year-on-year. And the fact that we saw algo volumes increase again during the first half of this year by 76% compared to H1 2020 suggests that the shift towards algo execution is likely to be a permanent rather than temporary feature of the FX industry.

In 2020 the volume of algo trading across 360T increased by +50% compared to 2019

In H1 2021 algo trading volumes across 360T were up +76% year-on-year.

Source: 360T internal data



Source: BIS, "FX Execution Algorithms and Market Functioning"

FINDING THE RIGHT LIQUIDITY

As the adoption of FX algos continues to increase, so too has the level of understanding around these products on the buy-side. One consequence of this is that firms are becoming more conscious that the liquidity which the algos are interacting with is as important (some might argue more so) than the actual construction of the algos themselves in terms of achieving the desired execution outcome.

This is why FX market participants are becoming more selective about which venues they deploy algos across, with multidealer platforms proving to be the most popular as they enable users to access algos from a wide array of different providers all in one place via one single point of entry.

Traditionally, firms have relied on their liquidity providers (LPs) to help them curate what liquidity their algos are facing, for instance they might want to only execute these algos across firm liquidity.

Now, however, we see clients taking this directly into their own hands. Rather than highlighting which venues they want their algos to execute across to their LPs, clients are instead utilising algo tiles which enable them to determine this for themselves. Thus, we increasingly see firms using such tools to select 360TGTX as an optimal venue for their algo to interact with because of the unique liquidity on the platform which can result in lower market impact when executing.

In addition to becoming more selective about venues, market participants are also becoming much more discerning about the liquidity pools within them. On the top-tier venues today it's possible to create bespoke, highly curated pools of liquidity designed specifically to help a given firm achieve the most optimal execution outcomes possible.

Source: BIS, "FX Execution Algorithms and Market Functioning"

Building and maintaining such liquidity pools requires deep expertise and the ability to conduct sophisticated analysis on execution patterns and liquidity conditions. Of course, not all firms who trade FX have the skill set to do all of this in-house, is why we see a growing demand for platforms to offer liquidity management services.

It's also worth pointing out that one reason the concept of algo execution is attractive to buy-side firms is that they can offer an extra layer of anonymity. Using a bank provided algo gives the first level of anonymity but then this is enhanced if a firm were, for example, to use one of the four central counterparties (CCPs) which offer a credit path to trade on 360TGTX.

This benefits the buy-side firm because the algo provider is likely to have more sources of liquidity available to interact with and then using the CCP model to trade anonymously on 360TGTX helps to minimise signalling risk and information leakage, leading to less of a footprint in the market.

BETTER EXECUTION

With the use case for algos having been thoroughly validated in recent years, the important question is: what comes next?

One ongoing trend is the adoption of FX algos across different client segments, with a particular uptick

occurring amongst asset managers and corporates.
Regulatory changes are one factor which has prompted this change in behaviour amongst asset managers. On the one hand, best execution requirements have caused these firms to look for ways of trading whereby the quality of their execution can be clearly quantified. On the other hand, capital requirements have reduced appetite amongst their bank counterparties to warehouse FX risk as it has become more costly to deploy their balance sheets. Algos help to alleviate both of these challenges.

The fact that asset managers are increasingly executing their FX trading across a wider variety of channels is also creating a virtuous circle as it causes liquidity fragmentation to increase, and thus bolsters the need for algos.

On the corporate side, algos have provided greater transparency, automation and sophistication across treasury desks. With a pre-agreed fee, firms can better anticipate execution costs while leveraging sophisticated execution algorithms with the ultimate aim of achieving a lower cost of trading.

These benefits are being recognised by corporates with research from Coalition Greenwich showing that these firms went from using algos to execute 10% of their Spot FX volumes in 2015 to 28% in 2017. Meanwhile, the Bank for International Settlements (BIS) indicated last year that some large multinational corporations are now executing about 20-25% of their total FX trades via algos.

THE NEXT FRONTIER

The use of algos is not just spreading across client segments, but also instrument types. Historically, they have most commonly been used to trade Spot FX, with the BIS estimating that 10-20% of the daily global Spot FX turnover, equating to $200-$400 billion of notional volume, is being executed via algos.

The next frontier where we see algos being deployed is the forwards market, and particularly in the NDF market. NDF liquidity continues to improve as the notional volume of these instruments being traded each day almost doubled in just the three year period between 2016 and 2019.

This improved liquidity has led to more demand for Streaming NDF pricing, and because this subsequently creates a tighter top-of-book spread in addition to a deeper order book it means that market participants are now getting better execution outcomes when utilising algos to trade these instruments. With an ever-increasing universe of data available in the NDF space, liquidity and market access naturally are becoming more commoditised while algos can provide greater sophistication in what is still a relatively untapped market.

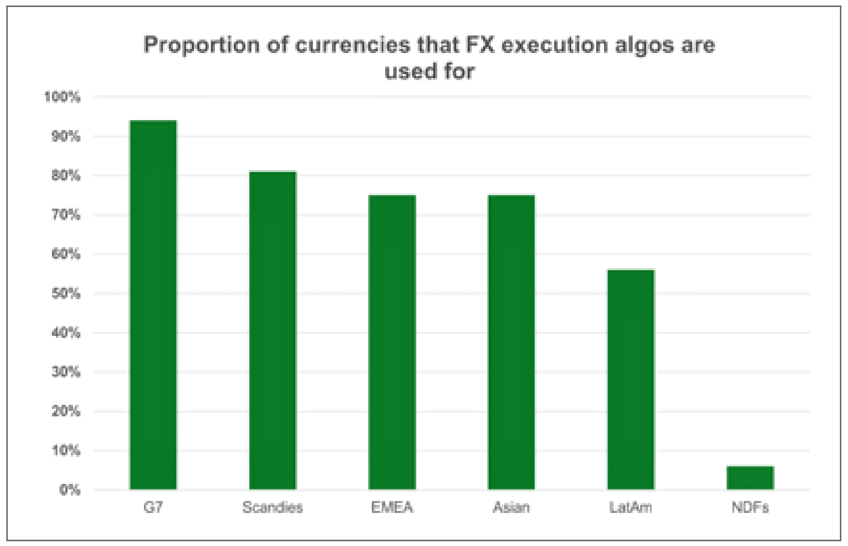
Another driver towards greater algo usage for NDF trading is the fact that more electronic trading venues than ever are offering access to these products, meaning that there are now more sources of liquidity for the algos to tap into.

Aggregating these different sources of liquidity together enables firms to create a more holistic view of a marketplace where liquidity can sometimes be thin, in addition to an order book to participate with. This helps to reduce signalling risk and market impact. In most instances it should also enable market participants to execute orders more efficiently as an aggregated streaming environment yields greater liquidity depth but also participation.

A CLEAR TREND LINE

At this point in time, the trend line for FX algo usage is quite clear and it is clearly pointing towards even greater adoption. As the products themselves become more sophisticated, platforms make a wide array of FX algos increasingly available to market participants and traders grow more comfortable using them, adoption will inevitably grow across both client and product segments.

Ultimately, the firms that we partner with in the FX market are looking for more ways of interacting with liquidity, and in this regard algos are simply one additional tool that can



Source: BIS, "FX Execution Algorithms and Market Functioning"