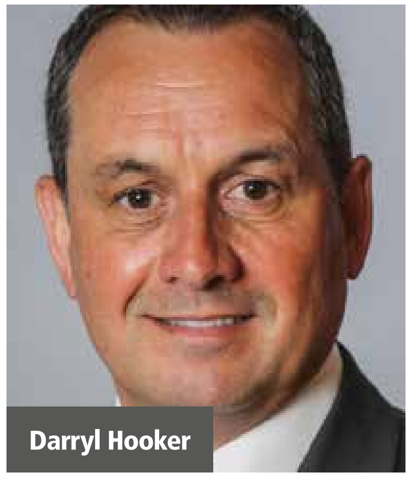
Streaming NDFs
Building a better marketplace

By Darryl Hooker Head of NDF strategy at 360T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The future of the NDF market has been a hugely popular talking point within the FX industry for the past couple of years, and now these conversations are focusing specifically on the availability of streaming prices for these products. But why?

To begin answering this question it's important to contextualise the interest in Streaming NDFs with the overall growth of this product segment. According to data from the Bank for International Settlements (BIS) the average daily volume (ADV) of NDF trading went from $130bn in 2016 to $258bn in 2019, meaning that this is a market which very nearly doubled in notional size in just three-years.

Moreover, there are plenty of reasons to expect this growth to continue. NDFs are largely used to trade local market currencies, which are increasing as a percentage of the overall global FX market. Over this period between 2016-2019 these currencies went from accounting for a 19% share of the overall global FX turnover to a 25% share, with an ADV of $1.65 trillion in the latest survey.

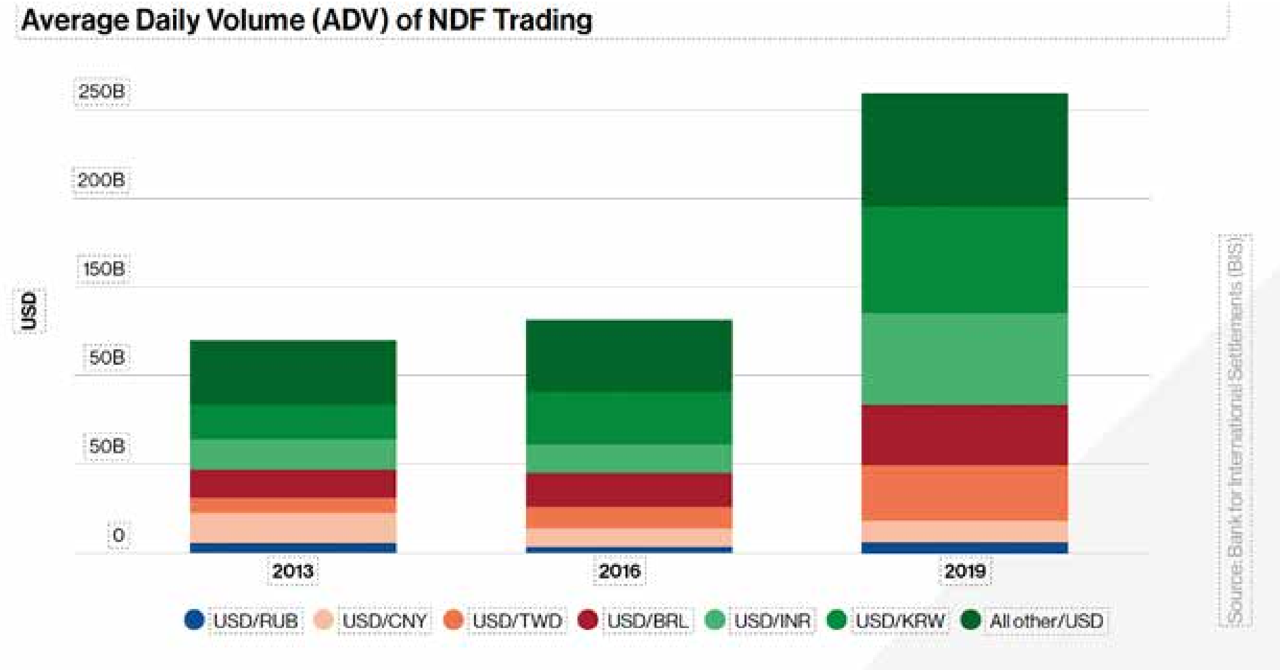
It seems logical that much of this was driven by broader economic growth trends — according to data from the International Monetary Fund (IMF) the average rate of GDP growth in what it designates as emerging and developing economies was 4.63% over this three-year period. And with a recent IMF forecast predicting 6.4% GDP growth for these same economies in 2021 it stands to reason that the demand for their domestic currencies will also increase.

TECH-CHARGED GROWTH

Technology has, and will continue to be, a hugely important part of this growth story too. In an article titled "Sizing up Global Foreign Exchange Markets" Andreas Schrimpf and Vladyslav Sushko from the BIS observe of the 2019 survey: "Trading in forwards between dealers and their financial customers exhibited the most rapid pace of electronification. Trading in NDFs constitutes a significant part of this activity. In particular, making NDFs tradable on electronic platforms has attracted greater volumes from hedge funds and proprietary trading funds." Just as we saw with Spot FX, the shift towards more electronic trading is making the NDF market more transparent, more robust and more efficient, ultimately leading to significantly increased trading volumes. And crucially, it is also enabling new participants to enter this market.

A separate BIS article, this time written by Nikhil Patel and Dora Xia, notes: "Hedge funds and proprietary trading firms can trade NDFs to arbitrage or take directional bets. In the process, they serve as natural counterparties to market participants who need to hedge currency exposures."

This ability to connect natural pools of onshore and offshore liquidity in different locations across the world is proving to be a massive driver of growth in the NDF market, and is something that we've observed ourselves at 360T. Broadly consistent with the numbers from the BIS survey, we've seen the ADV of NDFs traded electronically across our platform increase by 115% since 2016.



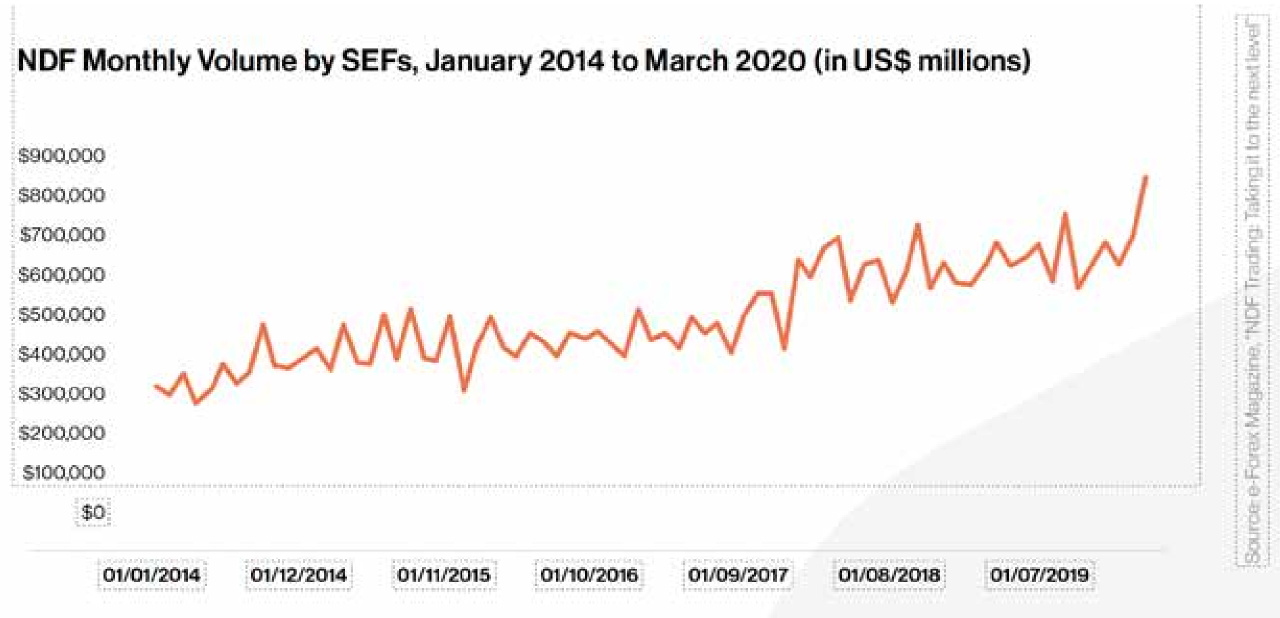
STREAMING BENEFITS

So there is a clear growth trend in the NDF market, and more specifically within the electronic NDF market, that seems unlikely to subside any time soon. More electronic trading leads to larger liquidity pools and the creation of more data, and this in turn helps to facilitate streaming pricing.

For evidence of why firms would want to access streaming NDF pricing where possible, once again we only have to look to the Spot FX market. While no one execution method is inherently better than another, what firms experienced in the Spot market was that streaming allowed for greater price discovery and enabled them to put more price streams from diverse sources into competition, with the spreads they were seeing tightening up as a consequence of this.

In addition, we've seen that streaming pricing is a good way to reduce signalling risk, which can cause the market to move away from the firm executing right before the point of trading and therefore have an adverse impact on returns. Streaming also enables market participants to leave passive orders in the market, offering them an alternative way to trade NDFs that is not available via requested pricing.

At 360T we think that looking at the evolution of the Spot FX market is in some ways a good guide for what to expect next in NDF trading, and that's why we offer access models and functionality for these products which



mirror those available across our Spot offering.

This means that clients are able to trade Streaming NDFs via GUI or API in either a disclosed or anonymous fashion on our platform, with deal tiles that are specifically mapped as OTC transactions and pre-trade credit checks available. The essential point here is that the trading experience is specifically designed to meet the different needs of the various client segments we support around the world.

Indeed, an important similarity is currently emerging between the Spot FX and NDF markets as liquidity in the latter is beginning to fragment just as it did in the former due to the emergence of more electronic venues which support the trading of these products. A crucial difference here, of course, is that the NDF market is much smaller and the liquidity is very much concentrated within just a few currency pairs, and even then predominantly within a one month tenor.

This means that the level of fragmentation seen in the Spot FX market — where today many different trading venues have been able to build out and maintain sizable liquidity pools — would likely prove more challenging for market participants trading NDFs as liquidity would become stretched much thinner. This is one reason why firms need to be considering which electronic platforms offer the best marketplace available for trading these products.

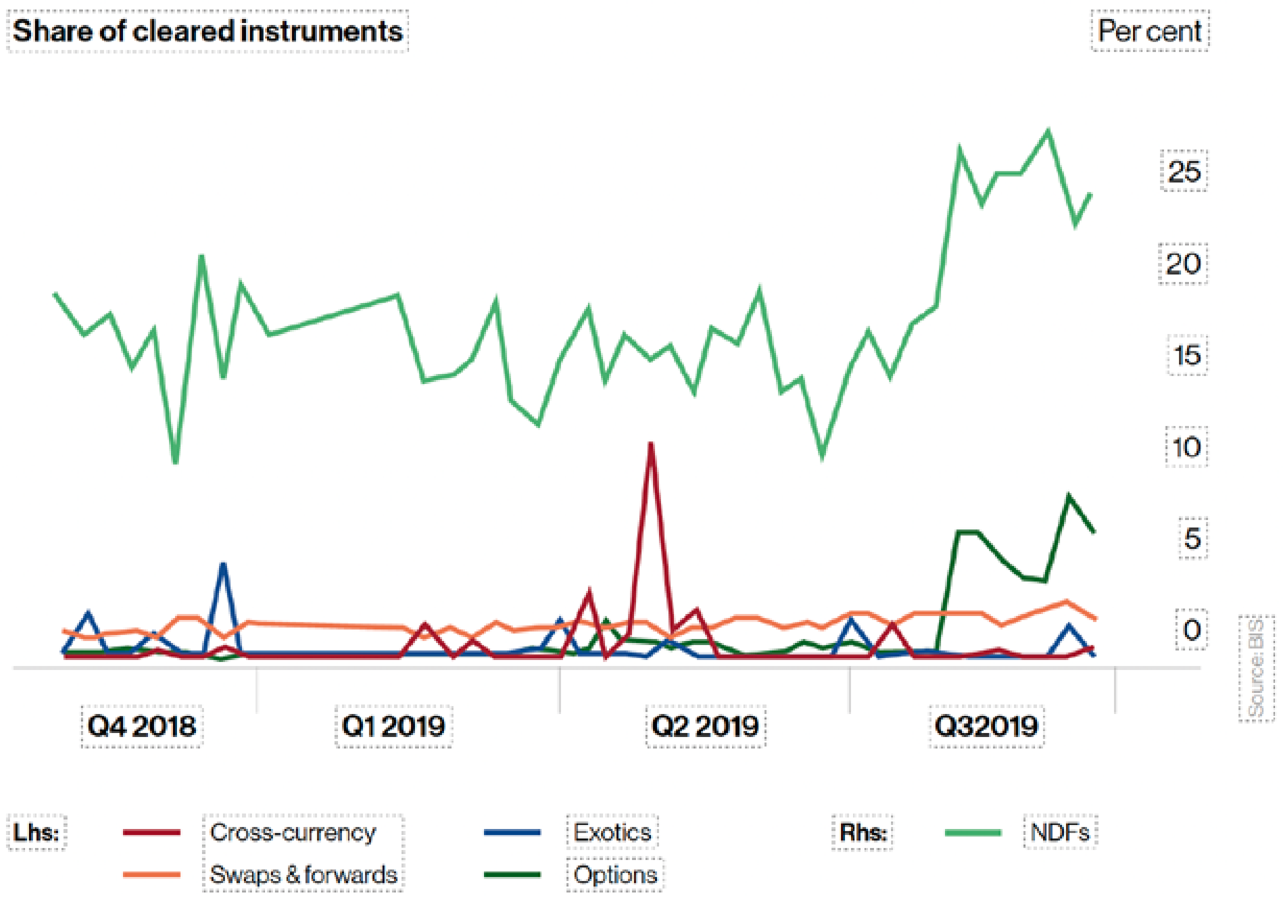
THE REGULATORY LANDSCAPE

Another point to consider is the regulatory environment for trading NDFs. The introduction through financial regulation of Swap Execution Facilities (SEFs) in the US and Multilateral Trading Facilities (MTFs) in Europe alongside existing OTC execution platforms has created a more fragmented landscape for NDF trading.

As a consequence of this, a clear divide has emerged in recent years between those platform providers who are now able to offer all of these different trading environments and those who can still only offer access to the unregulated OTC NDF market. As firms look to expand the amount of NDF liquidity that they can access, it may prove beneficial for them to partner with the platforms who can support both sides of the regulatory coin.

Credit is also an important part of this conversation around Streaming NDFs, as it facilitates a greater number and greater diversity of firms to participate in this market. As such, it's critical that firms look at the different credit models being offered by each venue.

Those who support both bilateral and prime broker (PB) intermediated credit relationships are likely to have a broader universe of participants, while those who offer access to trading via a CCP or central credit hub will probably have more still. With this more diverse range of interests present on the platform there are better opportunities for connecting liquidity providers and consumers.



WHAT COMES NEXT?

As the technological evolution of NDF trading continues apace, it is perhaps not surprising that there has been a sharp increase in the levels of interest around using algos to execute these products.

Streaming prices is obviously crucial to supporting this, as banks look to use the data from this activity to fuel and refine the algos that some of them are now offering to their clients. And on the buy-side we see that firms who are increasingly conscious about information leakage are keen to access any tools that might help them limit their market impact when trading NDFs.

Another development to keep an eye on going forward is the extent to which more NDF trading will shift to a centrally cleared model following the implementation of the final two phases of the Uncleared Margin Rules (UMR).

While these rules don't mandate NDF clearing they impose additional margin requirements for bilateral trading of certain products, meaning that in some cases it could become more economically advantageous for firms to centrally clear at least some of these products within their portfolios.

It's anticipated that many buy-side firms will be subject to the next two phases of UMR, due to come into effect in September 2021 and 2022, respectively, and these rules could have a significant impact on this segment of the market. For instance, the central clearing model allows firms to face the clearing house as a counterparty rather than each other, meaning that they are potentially able to trade with a broader universe of market participants at a lower overall cost.

THE DIRECTION OF TRAVEL

But while it might be unclear right now exactly how UMR will impact the NDF market, what is very clear to us today is that the direction of travel in this product segment is towards increased electronic trading and automation.

A GLOBAL MARKETPLACE

One of the primary considerations has to be the geographic reach, distribution, client base and presence of the electronic venue. Building up a platform to a global scale, both in terms of acquiring clients in various onshore locations and developing the local presence necessary to support such a widely dispersed client base, is a very challenging prospect. Consequently, the liquidity on some of the venues offering NDF trading today is heavily concentrated within certain geographic regions, meaning that there can be less diversity of natural interests. In contrast to this, 360T has spent over 20 years building a truly global FX marketplace. In 2020, we enabled more than 350 organisations across 35 different countries to trade more than 175 different NDF currency pairs. This still represents a fraction of our broader overall global community, which numbers over 2,200 buy- side customers and more than 200 liquidity providers in 75+ different countries, suggesting that there is plenty of fertile ground for further growth in NDF trading just amongst the firms which we are already connected to. All of which puts 360T in an unparalleled position to be able to connect firms in developed and developing markets worldwide, enabling FX market participants to access liquidity from regional currency specialists that they would not otherwise be able to interact with.

As an example of this, consider that in Brazil alone there are 27 local banks currently connected to 360T, many of whom will have natural flows from servicing their domestic client base and specific expertise in BRL currency pairs but are not otherwise connected to the global offshore market. Given that USD/BRL is one of the most commonly traded NDF currency pairs this represents a rich opportunity for firms to participate in a truly unique pool of NDF liquidity which delivers distinct benefits to both onshore and offshore market participants. To facilitate such a diverse liquidity pool 360T supports multiple credit models – bilateral, prime broker (PB) intermediated and via a credit hub/CCP — for trading Streaming NDFs, offering the maximum flexibility for firms wanting to trade these products.