The evolution of the FX Swaps market - How electronification is driving change

A famously staid market, FX Swaps have witnessed increased activity in recent times, bringing new challenges. Electronification is helping clients deal with them but bring issues of their own. Vivek Shankar explores how the market is evolving to account for these new factors.

Vivek Shankar

The institutional FX markets have experienced a steady increase in electronification. While the spot market has gradually moved towards sophisticated electronic solutions, the FX swaps market has held steadfast against this change. Trades are traditionally voice-based and counterparty credit checks require significant manual intervention.

However, thanks to the COVID pandemic and improved technology, there are signs that this last bastion of the old FX market is beginning to evolve. The Bank of International Settlements' 2019 Triennial Central Bank Survey of Foreign Exchange and Over-the-counter (OTC) Derivatives Markets highlighted that FX swaps' daily turnover rose by 34.7% since 2016, an additional $825 billion swaps traded per day.
This activity is far greater than the growth in the broader FX industry. Clearly, a few factors are driving the growth of this historically rigid industry. What are they and why are they proving so effective?

CATALYSTS FOR CHANGE

The first hint of major change in the swaps market occurred way back in 1997, with the introduction of Reuters' D2-2 for forwards. Despite much talk of the promise of electronification held for the market, there weren't any significant developments. Banks brought some degree of automation to swaps by including them as RFQs and streams on their single dealer platforms. A few MDPs followed suit but these moves hardly rate compared to the way the spot FX market evolved.

One explanation for the lack of change is that swaps have traditionally been an administration trade. As long as the spreads were tight, clients were happy with what they received. Challenges brought about by Dodd-Frank that caused cash hemorrhaging in the spot business also prompted banks to maintain the status quo in forwards, while they addressed those issues.

Paul Clarke, Head of FX Venues at Refinitiv has a few thoughts on the subject. "I agree, firms have been focussed on other instruments and business lines without having a specific issue to solve in swaps." Clarke also points out a few other reasons. "First of all FX Swaps, or at least in many pairs and for a large part of the curve, are not as liquid as other instruments such as FX Spot that are traded more electronically," he says. "There are also complications to trading swaps electronically such as credit and usage of collateral."

Finally, the flat interest rate environment since the financial crisis of 2008 has left banks with little money to be made in forwards. As a result, most banks are comfortable playing the role of a broker and facilitating customer business.

This picture has changed recently and has brought turbulence to a famously staid market. Traditionally, repos and

MARKET COMMENTARY

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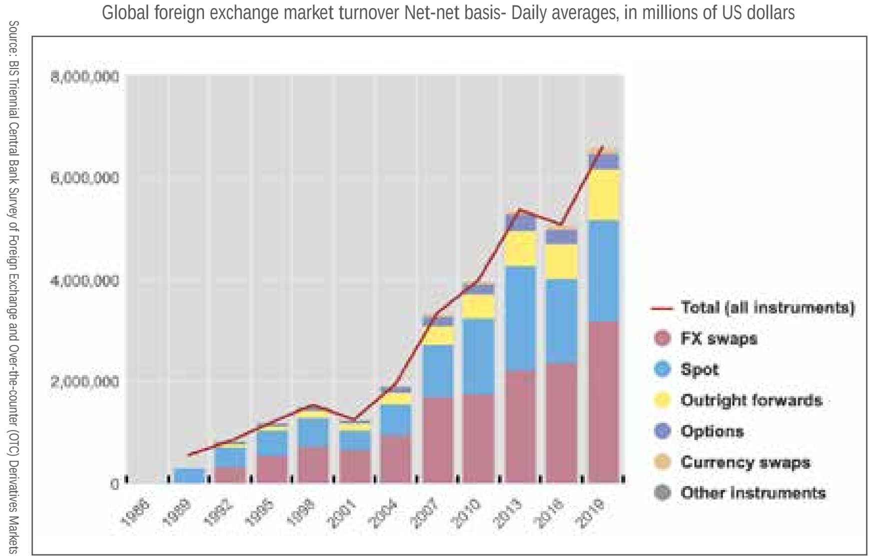

FX swaps' daily turnover rose by 34.7% since 2016

money markets have been the venues of choice for firms looking to roll, hedge, or fund their positions. These days, the FX swaps market is fulfilling these needs.

The off-balance sheet nature of swaps makes it easier for banks to meet tighter cash reserve and debt regulations, which has contributed to increasing FX swap activity. Furthermore, the evolution of standardized counterparty credit risk models ensures that swaps are the most cost-effective solution.

Robin Nicholas, Head of Swap Product at 360T Trading Networks (360T), believes regulation has driven change. "Regulation has played its part; increased capital and collateral requirements have duly increased the funding needs with FX swaps being able to provide a cost-effective means of meeting these obligations" he says.

Could the continued rally in the stock markets have anything to do with the rise in swap activity? Nicholas believes so. "It has driven increased passive hedging from other business lines too, led by the ongoing search for liquidity to satisfy this demand there has been a surge in demand for EFPs and FX swaps"

As a result, the swaps market is flush with new participants who are questioning the structure of the market and the viability of existing solutions. The suitability of traditional infrastructure is under scrutiny and is being deemed increasingly inadequate given the market's size and importance to the wider financial system.

The COVID pandemic placed the voice-driven nature of the market under scrutiny. Traders working from home found it impossible to deal with voice brokers efficiently, and this has precipitated a push for electronification from higher levels within banks. The costs associated with trading seats are also becoming an issue as regulation and the need for greater bottom lines make themselves apparent.

The result is a greater demand for automation, transparency, and communication in the market.

ELECTRONIC SOLUTIONS OPEN NEW OPPORTUNITIES

The interest in electronification is emanating from both the short and long ends of the curve. More clients are interested in becoming market makers by posting interest, something that pushed Refinitiv to launch their Matching Forwards API in 2020.

"eTrading groups want to be able to hedge their forwards exposure quickly and efficiently, and the API allows them to do that directly rather than passing orders and positions to their manual desk for execution" says Clarke. He also points out that increased volumes create a need for efficient swap execution, and the API allows banks to execute electronically along the curve.

"The API, and increased liquidity we see on the Forwards Matching platform," he explains, "give participants access to better prices and liquidity, and API participants have a wide set of counterparties to trade with."

Service providers are taking infrastructure costs into account when developing products, which is leading to innovative solutions. Peer Joost, COO of eFX pricing solutions provider DIGITEC is well aware of the need to reduce this burden when proposing solutions. "Only the largest banks can justify selecting a pricing engine for one asset class and even those banks are looking for increased efficiencies across their business lines," he explains.

"With this in mind we developed the D3 pricing engine to support a wide range of assets, including FX Swaps, NDFs, Money Markets, Precious Metals, Interest Rates and Crypto."

Refinitiv has also tackled the problem by simplifying their solutions. The company recently launched a plug-in that banks can use to publish prices, eliminating the need to code to their API. "Our Excel plug-in, called "MAPI Lite", allows clients to leverage their own pricing, submit orders and execute directly from Excel. That reduces coding for clients and allows

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Forward traders to price and trade along the curve more efficiently" explains Clarke.

Joost explains how these solutions feed innovation. "The combination of advanced pricing and analytics technology with data provision is a key differentiator in the FX Swaps market" he says. "There is a symbiotic relationship between D3 enabling increased automation and accurate pricing, which feeds the data in Swaps Data Feed (created in partnership with 360T). In turn Swaps Data Feed data improves the accuracy of other banks' pricing using D3."

At the short end of the curve, automated pricing has become a staple over the past few years. The rise of new market participants is also driving innovation. For instance, auto-hedging has long been a barrier to swap market electronification. Collateral management has always been a hot-button issue, and it has needed manual intervention to determine credit availability for short-term funding.

360T believes it has the solution for this problem. Coding to an API is impossible as long as a manual check exists. The company's 360TGTX MidMatch solution aims to remove this barrier. The product uses 360T and DIGITEC's Swaps Data Feed as a reference for grey-book mid-market risk exchange. 360T's Nicholas believes that the manual credit checking process that persists today can be automated. "Clients can utilise the 360TGTX MidMatch API connecting clients' proprietary credit systems directly or members can use 360T's sophisticated Limit Monitor to manage their credit allocations on the platform."

There are other benefits to 360T's solution as well. "The average duration of swaps is 65% under a week, and 92% under 3 months; the short date funding or the rolling of spot positions to the nearest IMM date have often been seen as administrative burdens," explains Nicholas. "360TGTX MidMatch removes the associated manual processes such as price discovery and manual credit checking by providing a centralised order book with the option to exchange risk at Mid and an automated credit process."

In addition, he points out that it also supports a number of fixed date forward forwards, in particular the IMM rolls, and the month, quarter, and year end rolls. "These are interesting to our members as their clients start to roll positions earlier to avoid the potential liquidity squeezes in the run up to the date" he says.

The aim is to enhance liquidity and improve price transparency, both of which are sorely needed as FX swaps become the funding vehicle of choice in the financial ecosystem. Products like 360TGTX MidMatch are also opening new opportunities in the market.

For instance, 360TGTX MidMatch creates the opportunity to earn revenue from auto-trading swaps and including them as a part of existing algo execution suites. Automated trading will reduce costs and increase efficiency, something that participants have repeatedly witnessed in the spot and credit markets. Spreads will also eventually decrease, which leads to a fairer price discovery process.

"Larger dealers and regional specialists can stream their curves and market make to the orderbook and also electronically post their interest at mid" says Nicholas. "We also see opportunities for automation for

The continued rally in the stock markets has indirectly led to a surge in demand for FX swaps

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Robin Nicholas

Treasury and funding desks in the short dates, and for members wishing to auto-hedge client interest."

DIGITEC's Joost believes that electronification is a no-brainer for firms in this space. "Increased electronification, automation and the use of sophisticated tools allow banks to increase their product range and, ultimately, their market making and trading volumes" he points out. For instance, "the combined services of D3 and SDF enable them to expand their offering beyond G10 and specialist currencies. Additionally, workflow efficiency is increased, enabling traders to diversify trading books and manage multiple instruments."

He highlights that DIGITEC clients "typically double the number of instruments they are pricing once the products are live", a clear indication of the benefits of adopting sophisticated electronic solutions.

CHALLENGES TO ADOPTION

Despite these advantages, there is significant pushback. Inertia is one of the causes. Voice-based brokers have been extremely effective in selling their services to the market, and have entrenched positions. Redesigning existing processes is a challenge, and for now, electronic solutions providers are working on augmenting existing workflows, instead of overhauling them.

Service providers are working on supporting traditional traders while enhancing the e-trader execution experience. Refinitiv's Clarke says "Manual traders will continue to get the benefit of improved pricing and liquidity that comes from the API order activity. As an all-to-all central limit order book, manual and API orders can match and trade with each other. The introduction of MAPI Lite is also intended to allow manual traders to execute more effectively, particularly if they want to make prices along a curve."

Automating credit approvals is also a challenge thanks to the subjective decisions that need to be made. A manual check solves this issue and coding that degree of subjectivity is a challenge. Some providers are proposing solutions that go a long way towards eliminating these concerns. For instance, 360T recommends integrating the institution's proprietary credit engine to 360TGTX MidMatch or using the company's Limit Monitor to create parameterized rules surrounding credit risk assessments.

Nicholas understands the concerns surrounding the electronification issue. "The subject of automated credit has certainly been challenging; understandably the industry has been wary of placing credit with third parties. However, direct engagement with credit and risk officers is helping us to win hearts and minds" he says. 360T aims to simplify these processes as much as possible.

To this end, Nicholas says that "360T offers a granular low latency pre-trade credit check tool that can be maintained manually or via REST API. 360TGTX MidMatch also provides simple API connectivity to a participant's own sophisticated credit engine."

Service providers are going to great pains to point out that while these challenges are significant, the benefits outweigh the costs. Ultimately, bringing transparency and efficiency to the biggest segment of the biggest market in the world is imperative. Electronification also brings various market participants together thanks to the certainty of a trade going through. Automated credit helps build confidence and eliminates the need for clients to post interest in a dark environment.

Joost highlights another challenge that DIGITEC has encountered. "A key challenge for us was that with the recent evolution and increased electronification of the FX Swaps market, smaller banks also wanted to use our services but could not justify the investment in on-premise technology." DIGITEC responded by developing a hosted service, deploying D3 to the cloud.

"This has made D3 available to an expanded group of banks and increasingly Asset Managers, as their technology requirements evolve. Since our launch of the Cloud earlier this year, 100% of new clients have connected to the hosted service" Joost says.

Currently, fungibility and the lack of liquidity are also proving a challenge.

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Peer Joost

CME's FX Link offers a cleared pool of liquidity for FX swaps, but it lacks access to an OTC forwards platform that can enhance liquidity. Blending a pool of OTC forwards and futures points to a possible opportunity that can affect the way the swaps market evolves.

Clarke however disagrees. "I don't think that we will necessarily see a blending of OTC forwards and futures. I think the evolution of the swaps markets, at least for the next few years, will be around more effective credit solutions." Nicholas believes that "..we have already seen venues providing the opportunity to transact futures, swaps, and EFPs. An increased fungibility between these liquidity pools would no doubt be well received. It is also likely that we will see more refined and erudite FX swap trading models via APIs."

FURTHER EVOLUTION

The lack of back-end infrastructure to monitor financial resource optimization in the face of increased regulation is having a side effect on the FX swaps market. A BIS working paper highlighted that G-SIB regulations were prompting bigger banks to pull out of credit and swaps markets at month and quarter ends. Furthermore, the study found that banks aiming to reduce their G-SIB rating through lower forward exposures received wider spreads at these times. The need for portfolio efficiency in interest rate markets might soon spill over to the FX swaps market, and this makes compression services invaluable. These services might result in better risk rebalancing, which in turn frees traders to offer tighter prices to clients.

UMR is another regulatory requirement that is driving change and it might hasten the creation of a clearing mechanism in the swaps markets. Dodd-Frank rules exempted FX back in 2014 thanks to the significant resources needed for building clearing infrastructure. Banks are also reluctant to adopt clearing because of the prospect of increased competition, similar to what happened with spot markets with the entry of non-bank market makers.

Nicholas says "The regulation and new capital model have certainly increased the client calls to and business with our colleagues in EUREX FX Clearing. UMR has been known about for some time, and so many are waiting to see the impact of September's Phase 5."

"We do expect Sa-CCR to have an impact on clients as it potentially requires participants to hold more capital as a result of their trading" Clarke adds. "This is something the LCH team in the LSEG Post Trade division have been looking at together with a number of their clients to build a proof-of-concept for clearing of FX forwards and swaps." Increased electronification is pushing clients towards SDPs, despite MiFID II regulations offering clients the promise of better execution on MDPs. As electronification aids greater customization, it remains to be seen to what extent clients will move towards SDPs that can offer tailored execution.

Finally, as with all talk of electronification, the role of human swaps traders is being questioned. Most service providers point out that technology isn't meant to replace humans, but augment their skills. Automation offers them a way to deploy their abilities in better ways, and increase bank bottom lines in the process.

NEW PROCESSES

The FX swaps market has resisted change for a long time but regulation, technology, and the need for transparency are creating new opportunities and solutions. As swaps continue to grow as a source of global funding, there's no doubt that the need for better infrastructure will increase.

As Clarke puts it, "It will take time for the Swaps market to evolve to being more electronic. There will be continued effort to improve efficiency, so I can see an increase in direct stream based execution in Swaps, and continued credit efficiencies to support the all-to-all markets which a lot of our clients tell us they value highly."

Nicholas foresees growth in the immediate future. "Our expectation is that FX swaps will continue to grow. The continued demands for FX swaps as a funding instrument, with reduced friction from new processes like streaming liquidity, auto-hedging, spread reduction through mid-matching, and the automation of pre-trade credit checking will all support this."