Image by Shutterstock

Look-ahead: What lies in store for us in 2023

e-Forex spoke to a number of key industry players about the year ahead and what we should expect for the FX market in several important areas including the post-trade process, technology, algo trading, digital assets and crypto.

STEVE FRENCH, HEAD OF FX & SECURITIES PRODUCT STRATEGY, OSTTRA, ON POST-TRADE FX TRENDS FOR 2023

With current macroeconomic trends pointing to continued volatility that will drive FX volumes in the year ahead, operations teams are grappling with the changes required to make post-trade FX processes more effective. The current shortcomings can be summarised as a persistent Gordian knot of post-trade plumbing, comprised of disparate processes and procedures that are intrinsically linked to the scale, complexity and decentralised nature of FX markets.

In 2023, these post-trade challenges will be in sharp focus, as volume growth combines with a trinity of longstanding forces that make change an imperative: evolving market structure, regulatory pressure and structural cost challenges.

Market Structure – Structural changes in market participation and trading paradigms will continue to drive post-trade change in 2023. Ongoing growth in the importance of non-bank liquidity across all products is changing the dynamics of traditional bank involvement and the risks in managing FX exposures. Shrinking spot margins, for example, are leading to greater automation efforts in FX swap and forward markets as well as growth in NDF and FXO liquidity.

The ongoing adoption of clearing is also likely to be a strong theme in FX markets in the year ahead. We anticipate continued uptake of clearing in bilateral direct-to-client and prime broker-client flows due to cost and execution efficiency, and some investment managers may look to consolidate margin exposures to fewer post-trade relationships. We will also see the first venue offering a cleared liquidity pool for NDF trading which is likely to trigger other NDF trading venues to consider offering different pricing for cleared NDFs versus bilaterally traded NDFs, further adding to this structural shift.

Regulatory Pressure – Ever present, regulatory change loomed large in 2022 and will continue to be a key consideration for FX business units in 2023. Margin reform and the transition from current exposure method (CEM) to standardised approach to counterparty credit risk (SA-CCR) are unfinished business that will need to be addressed on a practical level in the coming year, particularly when it comes to the cost of compliance. All parties are facing higher costs in trading FX products due to the margin reform and capital cost implications of the move from CEM to SA-CCR.

Additionally, settlement risks remain a major focus due to the FX Global Code, and intra-day funding and liquidity risk are a growing concern, particularly in this volatile market environment. We also predict that central banks will focus on large settlement exposures and excessive credit. This may lead to stronger compliance regimes if the FX industry does not “self-regulate” and is able to demonstrate that it is doing so.

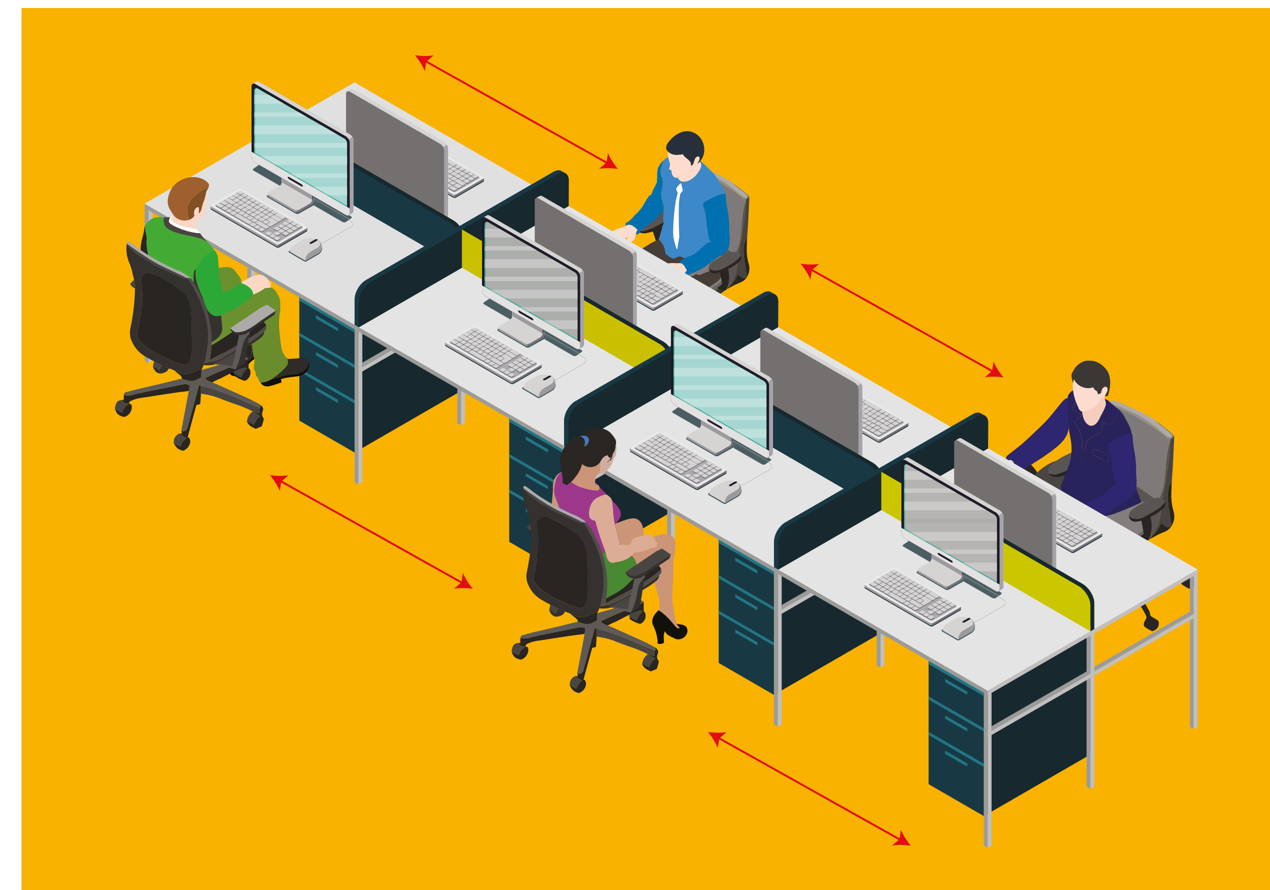
Structural cost challenges - Cost cutting and innovation in FX is a story that stretches from currency trading in Babylon in ancient times to Bitcoin in more recent years. But efforts so far have failed to deliver transformative and sustainable savings in an industry that typically operates with high fixed costs, based on decades of incremental change. Only breaking down internal silos and restructuring teams and processes to end data and technology fragmentation can result in a reformed cost base.

There can be no taboos when it comes to post-trade cost transformation – no isolated tech stack, no data silo can be left unconnected to achieve the straight-through processing that’s needed for a sustainable lower cost base. With firms focused on reducing the overall cost of providing client services, we expect increased automation, integration and uptake of hosted, managed post-trade services in 2023. Embracing this simplification will allow FX market participants to run their business more efficiently, while contributing to a lower, more flexible cost base in the years ahead.

JOHN STEAD, PRE-SALES AND MARKETING DIRECTOR AT SMARTTRADE, ON DEVELOPMENTS IN FINTECH

What will drive the growth of peer-to-peer trading models?

Peer to peer like any innovation needs a good foundation that includes technology, credit, regulations. Then we also need a driver / compelling event such as liquidity depth and spreads. Without a USP, there will be little incentive for traders to change. At the moment we don’t see many of our clients asking for connection to such venues. My feeling is the foundations are there but the compelling event or drive to push more clients is still emerging. If the liquidity, spreads, or market impact was to be significantly different or should some other USP come to the fore then this might be a different story. It is an area we are keeping a close eye on and will certainly be ready to support any initiatives here.



During the pandemic, we saw the benefits of automation in terms of reduced operational risk and increase efficiency.

Will we see greater use of AI and ML for FX trading applications?

Yes but not just in terms of greater use of AI and ML but also a more integrated approach to using the outputs of such analysis. The concept of mining data for value has been a well-trodden theme for many years now. In the past, getting the results of any analysis into a usable format has been less automated and more manual than was ideal.

smartTrade is already able to generate alerts for actions, benchmarks, or trends on the back of ML/AI analysis. The feedback we have from our clients is that they now need the ability to join this data up with other bank logic to provide greater automation and deliver faster results as they strive to refine services versus their peers. They want the ability to take the signals from the models, put them into code and have the platform self-adjust. It is the last bit of the puzzle. I believe this will be possible in 2023.

While the technology can be used for trading, it will be most effective for customer management. For example, a client is assigned to a cluster according to an ML model. If they then move from a low-impact cluster to a high impact cluster, the technology should be able to adjust the mix of hedging liquidity providers to protect the bank’s relationships with its LPs and to ensure best execution for the client.

Will 2023 see a role for DLT/ blockchain in the FX market?

Despite the recent market turmoil we still see a steady stream of new business here. Our prediction is that whilst DLT/blockchain and the general cryptocurrency market are less prominent than in past years, the sector is strengthening its foundations and will emerge much stronger than before. Certainly, for smartTrade in particular, we will continue our investment in offering such services and building partnerships with key industry players to enable our clients to thrive even in these uncertain times.

Eugene Markman

EUGENE MARKMAN, FX COO, ION MARKETS (FX) ON THE GROWTH IN ELECTRONIC TRADING, REGIONAL TRADING HUBS AND THE USE OF APIS

What factors will drive the growth of exchange-based and OTC FX trading in 2023?

The growth will be proportional in both listed and OTC FX trading and will be a continuation of the last two years, primarily driven by volatility that will continue in 2023 and beyond until we get a period of market and political certainty. We will continue to see growth in non-spot FX as dealers are becoming more technologically sophisticated. In the spot market we will continue to see spread compression, leading traders to less optimised markets such as NDFs, Swaps and options. We are also seeing more development of algos from market-makers as they look to provide additional products to clients as well as additional revenue streams and to improve their P&L.

What regional FX trading hubs and emerging market FX trading hotspots will emerge in 2023?

Last year we saw a change in how EBS functions and that will have an impact on the volume of trading in the main regional trading hubs. Trading in G10 currencies was previously split between New York, Tokyo and London but will now be centralized in New York. This will generate latency issues for trading firms in Europe and will likely lead to more activity on secondary venues such as CBOE and Euronext. Other beneficiaries will be the single bank platforms that have lower fees than EBS. Conversely, the NDFs and emerging market currencies will be mainly traded in London and will therefore raise similar issues for US-based traders.

In Asia, the shift is from Tokyo to Singapore. The Monetary Authority of Singapore (MAS) has invested heavily to entice global FX firms to set up their primary Asian trading venues in Singapore. It has taken time for liquidity to reach critical mass, but we are now seeing an uptick. One factor that persuaded the MAS to invest was the opportunity to create a global center for Chinese yuan trading, However, for Singapore to become the dominant FX trading hub in Asia, it will need to be center for Asian FX trading for all currencies and not just the yuan.

Will we see greater use of APIs in eFX trading in 2023?

The prevailing attitude now is to automate. During the pandemic, we saw the benefits of automation in terms of reduced operational risk and increase efficiency. We also saw an increase in electronic trading and I see no reason why that growth would stop. An additional driver has been the rise of APIs which enable automation and electronic trading. It was always the case that there needed to be sufficient volume to justify the initial investment in automation but the use of APIs has lowered that threshold to a degree.

Overall, it is a mind-shift. If you compare today's FX trader to one from 20 years ago, the profile is totally different. Today they are likely to be a quant who can code, especially in the FX market where the products are straight-forward but the market is very complex. In many ways, it is a parallel to what we have seen in everything else in the world that has gone from analogue to digital.

Simon Jones

SIMON JONES, CHIEF GROWTH OFFICER, 360T ON THE DEMAND FOR ELECTRONIC TRADING AND TCA

What factors will drive the growth of electronic FX derivative trading?

At a high-level, the drivers towards electronic trading in the FX derivatives space are the same ones we've witnessed in other product types and asset classes — namely, the desire to streamline the execution process, reduce costs by more effectively putting different pricing sources into competition and minimise the operational risks inherent in manual processes. Drill down a layer deeper though and we see some specific factors that are now accelerating this trend.

An important one is the commitment from FX market participants to address and upgrade their legacy credit engines. Credit has long been a bottleneck preventing more FX derivatives volumes from trading on electronic channels, but now we're seeing new tools alleviating this issue coming to market. A prime example of this is in FX Swaps, where 360T's Swaps User Network (SUN) has replaced the manual checking of available credit limits by both parties at the point of trade with several automated credit solutions that safely enable trade confirmation in fractions of a second.

Another factor is the broad recognition in the marketplace that the risks associated with the use of voice channels are disproportionate when compared to the returns observed using electronic execution channels. And again, this is something that we've already seen play out in other FX products and asset classes prior to now.

Pioneers of fully automated execution in FX Derivatives are already demonstrating in a quantifiable manner the benefits of utilising order types historically used in other markets to trade those products. This should create a draw for other firms to subsequently shift more of their FX derivatives trading activity towards electronic channels in order to similarly deploy these additional order types. At a basic level, information leakage can be greatly reduced using these new tools, along with the extended reach that existing mediums don't efficiently replicate.

Will we see greater demand for TCA and what will drive it?

It's inevitable that there will be greater demand for TCA within the industry because of the simple fact that people always want more trading metrics at their fingertips than they have now. And frankly, the drivers for this remain the same as ever. TCA can help to produce greater efficiency around FX execution by using observable metrics that can be used to drive decisions that improve the process.

However, a change that I do think we'll see in 2023 is an acceleration in the demand for transparency. What I mean by this is that market participants will want, and increasingly expect, to be granted more insight into things such as execution protocols, platform protocols, algo strategies, policies around last look and hold times, etc. This is partly a result of the work done by the GFXC in recent years — and in particular last year — which has paved the way and encouraged FX market participants to ask more detailed and in-depth questions of their providers and intermediaries.

Jenna Wright

JENNA WRIGHT, MANAGING DIRECTOR, LMAX DIGITAL, ON DEVELOPMENTS IN THE INSTITUTIONAL CRYPTO AND DIGITAL ASSET SPACE

2022 was clearly a challenging year for digital assets, with market events driving a raft of negative sentiment towards the nascent asset class. Despite this turbulence, it is worth noting that large financial institutions continued to invest in the digital assets and blockchain space in the second half of the year.

Looking at 2023, we would expect a more muted approach to investment, certainly in the early part of the year. Over the long term, we remain convinced that blockchain technology and crypto currencies will pervade traditional capital markets, from an institutional perspective. In our view, for the potential of digital assets to be fully realised across capital markets, a strong regulatory framework is crucial.

The current lack of regulatory clarity has prompted the growth of offshore, unregulated crypto businesses which has put consumers at risk and pushed them away from safer jurisdictions. With a focused and coherent global regulatory framework, we can protect consumers, create financial stability, liberate the institutional market and foster responsible innovation within capital markets, allowing the market to mature and ultimately flourish.

Across the US, UK, EU and Asia, regulators are focusing their attention on crypto like never before, whether that be rightly cracking down on violations around insider trading and fraud, or imposing standards to protect consumers and reduce market fragmentation.

Whilst progress is encouraging, we would like to see policymakers across the globe working with the industry to ensure frameworks are robust, effective and under the supervision of respected regulatory bodies.

In the absence of regulation, those companies in blockchain and crypto need to act as if they are regulated now. As a longstanding operator of FX exchanges, we have applied robust risk and governance controls to our crypto currency business from day one. For confidence in the crypto industry to be rebuilt, basic principles of risk management, transparency

and corporate governance must be adopted and adhered to. This will benefit the industry, providing an opportunity to focus more on the cutting-edge technology behind the asset class and its use cases. In addition to protecting consumers and creating stability, regulation also harvests innovation. Crypto has the potential to change the velocity of money and it is important that the industry continues to innovate, particularly in a more challenging and competitive macro environment.

The current crypto winter is a period in which all market participants in this asset class should be working together to build the ecosystem and strengthen market structure. It is important to remember that we're in the early stages of crypto market development. In 5 to 10 years, crypto could be a $10tn industry.

Keith Tippell

KEITH TIPPELL, CHIEF PRODUCT OFFICER, CLS ON DEVELOPMENTS IN FX SETTLEMENT

What developments will we see in terms of FX settlement?

In 2023, we expect to see continued growth in payment-versus-payment (PvP) settlement via CLSSettlement. Over the last few years, there has been a nearly 25% increase in legal entities accessing CLSSettlement as third-party participants. With this growth, CLS now settles on average over $6trn per day for over 70 settlement members and 30,000+ third-party participants, including banks, funds, non-bank financial institutions and multinational corporations.

To address the issue of growing settlement risk for emerging market currencies, we are increasing investment in CLSNet, our bilateral payment netting calculation service designed to drive operational efficiency and mitigate risk for currency flows not settled in CLSSettlement. In 2022, we saw record growth in CLSNet, with a year-on-year increase of 329% in average daily notional of net calculations.

What industry initiatives will reduce settlement risk and the post-trade space in general?

Over recent years there has been a significant amount of focus on FX settlement risk mitigation from both public policy makers and the industry, and we expect that to continue in 2023. The FSB has been making progress with its G20 Roadmap for Enhancing Cross-Border Payments, including building block 9 which focuses on the mitigation of settlement risk. Settlement risk mitigation in the FX industry has also been encouraged through updates to the settlement risk principles of the FX Global Code regarding PvP and netting. The updates emphasize that market participants should reduce their settlement risk by settling FX transactions through services that provide PvP settlement and encourage the use of automated settlement netting systems (which CLSNet supports).

As a financial market infrastructure (FMI) that operates the predominant settlement system for FX, CLS has long been a proponent of PvP adoption in order to mitigate FX settlement risk and has worked closely with both the public and private sectors to highlight its importance. CLS will continue to monitor developments closely and collaborate with the industry and the public sector to find ways to further mitigate risk across the FX industry.

As far as T+1 settlement is concerned, there are some important developments in the securities market. We have been engaging with our members and industry bodies on this topic. CLSSettlement supports T+1 transactions, so there is no immediate gap that needs to be addressed. More broadly, we are closely monitoring potential market requirements for intraday liquidity optimization. We are consulting with our members on the potential requirements and, should it be required, we can operate new and separate settlement sessions through the multi-session capability of the CLSSettlement technology platform.

Will we see greater adoption of PvP solutions, and what will drive it?

In the last three years, the average daily value of transactions settled through CLSSettlement has grown by 11% percent. This is largely due to our settlement members and third-party community of asset managers, corporates and regional banks increasing the volumes of payments settled in CLSSettlement. Last year, we saw a 25% increase in the number of third parties using CLSSettlement, and almost a 10% growth in third-party settled values.

Asset managers contributed most to this growth. They recognise the need for strong infrastructure to mitigate FX risks and provide liquidity and cost benefits. In addition, many other firms are moving to a multi-dealer model and are not always trading FX with their custodian bank where settlement risk is eliminated – hence the need for a settlement platform to mitigate risk and enhance operational efficiency.