What does the future of FX trading look like?

Carlo Kölzer, CEO of 360T Group and Global Head of FX at Deutsche Börse Group, sees a number of trends emerging that will shape and change the FX market.

Carlo Kölzer, CEO of 360T Group

With 2022 — another year that produced big surprises for both financial markets and the world more generally — now firmly in our rear-view mirror, it's worth reflecting which trends that emerged in the FX industry are likely to continue into 2023 and what new unexpected turns we should be preparing ourselves for.

In order to avoid such ruminations sprawling to the length of a doctoral thesis, it is perhaps most effective to consider the evolution of this marketplace along the lines of different FX instrument types.

Last year was an interesting one in the FX Swaps and Forwards market largely catalysed by the interest rate movements across most major currencies.

The Bank for International Settlements' (BIS) 2022 Triennial OTC FX Survey showed that these two instruments now account for $4.8 trillion of notional volume per day, or 64% of all FX trading globally.

These are also the fastest growing segments of the FX market (although the BIS survey doesn't distinguish between Outright Forwards and NDFs), with daily trading volumes of FX Swaps up by 19% and Outright Forwards up by 16.5% compared to the last survey in 2019.

This growth could potentially also be emphasised by the fact that some of the biggest technological developments in our industry in recent years have been focused on these instruments, although the issues facing the sell-side and the buy-side are very distinct here.

A BETTER WAY TO TRADE

In the interbank FX Swaps market the participants would historically execute trades with some form of electronic risk management, but the ability to seamlessly execute an automated hedge was lacking and the process relied upon the manual checking of available credit limits by both parties at the point of trade.

Today, this has all changed. The data, tools and technology are now available to enable sell-side institutions to risk exchange at midmarket through full API connectivity utilising a range of automated credit models to enable this. And all of it can be done via a fully regulated trading platform - 360T's Swaps User Network (SUN).

Not only this, but the technology is designed to enable more efficient, streamlined trading while still retaining all of the key benefits associated with the more manual legacy execution channels, such as explicitly stated minimum clip sizes to assist with the prevention of low-cost information gathering and the availability of different order types.

SHIFTING BUY-SIDE CHALLENGES

On the buy-side we've seen the adoption of high-quality data sets combined with advanced automation tools being used to streamline and enhance how they trade Outright Forwards and FX Swaps, often by automating parts of, or in some cases the entire execution process.

This adoption has thus far been uneven, but the pioneers in this space have now effectively created a roadmap that others can now follow. But while this might sound straightforward, it is important to bear in mind that while there are certain workflow elements that tend to be common among buy-side firms, each one contains unique parts too.

Hence, in 2023 we see the challenge shifting from producing the data and technology needed to automate Outright Forwards and FX Swaps trading to now calibrating and applying these to the specific workflow challenges associated with each firm's trading activity. We see the connection between pricing and hedging becoming a lot tighter in the future, with traders gaining greater control of their risk as a result.

CREATING A MORE DIVERSE LIQUIDITY POOL

In the past couple of years we've seen a resurgence of ECN platforms, such as 360TGTX, and this is likely to be maintained in 2023. Last year FX volatility clearly played an important role in the overall performance of these platforms, but technical enhancements are also having an impact.

ECNs are increasingly benefiting from offering flexible credit models which enable users to access the liquidity available there via different channels. This flexibility broadens the universe of market participants who can trade on the ECN, helping to create a more diverse Spot FX liquidity pool.

And a broader theme that we're likely to see across this market is the acceleration of an existing push to break down different liquidity silos. This will enable a wider range of different market participants to trade with one another and thereby maximise the trading opportunities available to them.

ENFORCING BEST PRACTICES

But probably the biggest story in the ECN space last year was the move made by some of them to to mandate compliance with the FX Global Code of Conduct, a principles-based set of industry best practices. 360TGTX was at the vanguard of this trend, announcing that only signatories to the latest version of The Code of Conduct or market makers offering firm liquidity will be able to make prices anonymously on the platform.

This was applied across anonymous Spot and NDF trading for both full amount and sweepable liquidity, where counterparties are not known to each other and the absence of a relationship or the opportunity to engage in a dialogue places 360T firmly in the middle of the trade.

The logic behind this decision was that market makers will have a better experience when they can be confident of operating in an environment which is consistent with the agreed upon industry best practices, and market makers will in-turn benefit from this confidence. The end result will, we believe, create an improved ecosystem for everyone.

I think this is also a great example of how the FX industry is using The Code to improve the marketplace. When The Code was being developed and launched, many people questioned whether it would be effective, given that it does not have the status of regulation and adherence is only on a voluntary basis.

However, firms like 360T have seen how the principles of The Code can help to promote a robust, fair, liquid, open, and appropriately transparent market, and have now taken steps to significantly increase the incentives for adherence.

THE CONTINUED EVOLUTION OF NDFs

Last year it was clear that NDFs are following along the same path that the Spot market went down many years ago, with more activity going towards electronic channels (NDF volumes on 360T increased by 78% in 2022) and streaming pricing inevitably becoming more and more prevalent.

In 2023 another way that the NDF market will follow in the footsteps of Spot FX is in the usage of execution Algos. The growth of Algo trading within the Spot market has been well documented in recent years, and it is inevitable that as NDF trading continues to evolve and mature we'll see these tools deployed there as well.

In reality, the technology is already there. Banks use Algos for trading NDFs in the interbank market and have begun making these available to clients too. And as the liquidity improves in this marketplace, and especially if it fragments across different platforms like in Spot FX, the advantages of using Algos will become very apparent and we'll see an increase in adoption.

A BOOST FOR FUTURES

2023 could also herald some shifting dynamics in the FX Futures market. An amendment to regulatory capital rules has changed the way in which derivatives exposures are calculated, now using a methodology called the standardised approach to counterparty credit risk (SA-CCR).

The introduction of SA-CCR could lead to a higher capital burden for banks when trading certain products, including FX Swaps and Forwards, which could make FX Futures seem like an enticing alternative for market participants.

We're also seeing growing demand for products that can act as a bridge connecting OTC liquidity and FX Futures, such as Exchange for Physical (EFP), which could accelerate further in the coming year.

For those unfamiliar with EFP, it is an off-exchange relationship trading transaction that allows an OTC position to be built, then reported into the exchange to effectively roll this into futures. This enables market participants to interact with the deep, highly liquid OTC FX markets that they are familiar with, and using the tools that they already have at their disposal, while also providing all the benefits that central clearing can offer.

REGULATORY CLARITY

More broadly, we think 2023 will be the year when we get greater clarity on the impact that regulation will have on the behaviours of FX market participants. The adjustment to SA-CCR is obviously one example of this, but another is the recent opinion paper published by the European Securities and Markets Authority (ESMA) regarding the rather philosophical question of when a trading platform is actually a trading platform.

In the past there has been some debate about which technology providers should be required to register as Multilateral Trading Facilities (MTFs) under MiFID II.

At 360T we took the view at the outset that it was important to provide our customers with a trading environment which meets the highest standards of regulatory adherence so they can be certain of meeting all their compliance obligations, both now and in the future.

Recently ESMA has sought to end the debate in its opinion paper we feel further vindicated in this approach. Now that it has been made clear what trading activity should occur on regulated platforms, we think that some FX flows will drift towards the regulated environments that already exist in the year ahead.

But while on one hand we see the impact of regulation coming into sharper focus now, on the other we see regulatory rules fragmenting along geopolitical lines. The regulatory requirement for providers to create separate entities in Europe and the UK is only one example. This trend will ultimately require increased investment and will add more complexity for FX market participants, driving them towards partners who have global and regulated operations with localised expertise.

A THRIVING MARKET

These only represent a partial glimpse at some of the key trends that we see shaping FX trading in 2023, but readers will notice that certain themes — such as electronification, automation, data and access to unique liquidity — reoccur to varying degrees across each instrument type.

This suggests a very positive future for the FX industry as a whole as it suggests that the marketplace will continue to become more robust, transparent and efficient. In 2022 the FX market demonstrated that it is capable of handling unexpected news and heightened volatility, in 2023 I believe that it will prove an ability to thrive regardless of what world events or financial conditions we encounter.