Avoiding investment regret – assessing potential alternatives to PIT execution strategies in FX

Following the recent recommendations from the Financial Stability Board, Frances Faulds looks at the perceived benefits and drawbacks of using the Fix, and what is most likely the way forward for the FX industry.

It is generally recognised across the FX industry that although the 4pm Fix has grown up over the years, it is an inefficient trading methodology that is long overdue a serious overhaul. No one could have predicted that the WM/Reuters rate would have become such a popular traded rate but it is a situation that cannot continue and it is up to the FX market to change.

Speaking at *FX Week*'s Australia conference in Sydney last month, Guy Debelle, assistant governor (Financial Markets) of the Reserve Bank of Australia and co-chair of the Financial Stability Board, told banks the time to introduce transparent fee-based pricing is now. However, the FX Benchmark Group's report, containing 15 recommendations aimed at improving the benchmark process and reducing the incentives for manipulation, also criticised the lack of understanding by some asset managers and index providers of how the market benchmarks work, and how they transact with dealers.

Chip Lowry, Senior Managing Director and Head of Agency FX Services, at State Street Global Markets says that current situation is a direct result of reference indexes becoming investible indexes.

For example, MSCI EAFE is a well-known benchmark which has been a standard for measuring relative performance for international portfolios. EAFE uses the WM/Reuters mid-rate benchmark in its calculation. Over time, people wanted to invest in the benchmark and not just use it as a reference rate.

Lowry says: "The construction of these indexes uses the WM/Reuters mid-rate. Thus, if a portfolio manager is attempting to replicate the index, he must also attempt to trade at the same rates. Here you can see where the demand for the obtaining the WM/Reuters mid-rate comes from. It's a direct result the index companies originally choosing the WM/Reuters mid-rate for construction of the index. This isn't a WM/Reuters problem. It's an index construction problem."

"With the ability to trade at the mid-rate now established", Lowry adds, "the WM rate obtained some very nice perceived qualities – it's perceived as being low cost, as transparent, as liquid, as size independent. People came to believe they could trade any amount at that price and as a result, it was seen by some as a safe harbour. This led to people who weren't replicating an index to choose it for general trading purposes."

Before the initial allegations were documented sometime in 2013, banks were routinely offering unlimited amounts of liquidity at a future, unknown, mid-rate price ostensibly for free. That does not sound like a sustainable business model. Lowry says: "Charging for this would make the business viable and the costs more transparent, and this is why is has been recommended by the Financial Stability Board."

OPTIONS TO THE FIX

The FSB clearly states that banks should not be trading at the mid-rate but at the traditional bid/ask with clients, or at mid-rate with an agreed and disclosed fee. Tracking error will increase but as everyone's tracking error is going to up, Lowry believes that no one will be disadvantaged by these recommendations.

As guaranteed mid-rate trading goes away, the buy-side has several options. The first option for the buy-side is the review the actual need for the rate. If they are not replicating an index, perhaps they should consider changing the way the trade.

Beyond that, for those that do need the rate, they can still trade with a principal. Those prices will most likely be closer to bid/ask than mid. They could also attempt to trade actively themselves in order to replicate the mid-rate. That may necessitate the use of a prime-broker set up which many institutional buy-sides have not historically used.

What Lowry believes is more likely is that investors will look to use algorithms, which are commonly available from banks for electronically traded currencies. However it will most likely be the case that different algos will give slightly different rates for the same currency. This will cause price-consistency issues.

While new algos are expected to come to market, Lowry says that the last option open to investors looking to replace the Fix, is to use an industry-lead

Chip Lowry

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netting utility. This option is explicitly endorsed by the FSB. While there are a lot of crossing utilities preparing to come to market, it is not a wholly new concept; State Street has had one live since October of 2014, called TruCross.

A utility brings many advantages. Typically in a utility, information is not shown ahead of time; it is available for electronically traded currencies and offers consistent rates. As users are crossing with other participants in the utility, the rate is more likely to be closer to the mid rate than any of the other options. However, Lowry warns that this model is not going to be able to handle every currency, only those electronically traded. He adds: "Although it is early days, I think a utility is where people will probably get the closest to the mid-rate. Several have been announced and a few will come to market soon but the issue with any utility will be how good it is, and where it is going to execute the liquidity."

However, going forward in this new landscape, he believes investors will struggle with how to jointly maintain diversification of credit exposure while simultaneously receiving a consistent price. "One of the attractive aspects for trading a mid-rate was that regardless where you traded, you received the same price. This allowed people to maintain price consistency and diversify their credit exposure." Going forward with multiple offering resulting in multiple prices, he thinks this will be difficult to maintain. For this reason he thinks utilities will win out.

CROSSING NETWORK

For Michael DuCharme, CFA, head of currency strategy at global asset manager, Russell Investments, part of the answer is in the reason they adopted the fix rate in the first place – the lack of published rates in the FX market. The need for portfolio managers to have a common set of exchange rates with which to compare their international portfolios with a set of benchmarks became very popular, very quickly, in the early Nineties, and still remains today. "After a while, what was developed as a performance benchmark became an execution benchmark for managers interested in minimising tracking error to the benchmark," he says. Banks started offering the WM/Reuters benchmark, at a mid-point price and the situation we have now grew up from there.

However, while the published rate solved a lot of problems, it came with consequences, culminating in the recent accusations of collusion and subsequent criminal charges. Indications are that banks will now start charging compensation for providing WM rates and the industry is currently working on what that cost should be.

The FX market is dynamic over its 24 hour period of activity.

"One doesn't have to trade at a point in time to demonstrate best execution. There are other ways to trade cost-effectively and efficiently and then use transaction cost analysis to evaluate costs and trading strategies and adjust those strategies as necessary."

In response to this and the ongoing consultation around the use of the Fix, DuCharme says that Russell Investments has developed an execution service, in conjunction with Integral Development Corporation, designed to fix the Fix. The Russell FX Network (RFX Network) offers improved netting for institutional investors along with a facility to match buy-side interest at mid-rate in a bid to improve operational efficiencies while minimising market impact. Moreover, the network is designed specifically to help institutional investors, including asset managers, obtain currency exchange rates that seek to minimise tracking error with respect to the rates published by WM/Reuters.

Says DuCharme: "What we are aiming to do is to help investors get as close to the WM rate as possible by automating the execution of complex trade lists in a novel solution that combines internal netting within an investor's trading portfolio with external matching amongst the larger buy-side community."

Users can benefit from advanced netting, process automation and best execution while minimising market impact of their orders by placing orders electronically into RFX Network or have Russell Investments process them on their behalf. Fixing orders are matched with other investors, while any unmatched residual is executed by an innovative trading algorithm that mimics the Fixing process to minimise tracking error, helping plan sponsors and asset managers manage their fiduciary responsibilities involving executions that historically have been costly to trade and difficult to evaluate.

Orders are matched with one another in the RFX Network at the WM rate, fifteen minutes before the hour. Any residual left over following the match is taken to market and traded using algorithms designed to minimise the tracking errors of the WM rate and this rate is blended back into the matched trades so that an average weighted rate is obtained. Institutional investors can use RFX Network now for trading at non-fixing times as well as at the Fix beginning in the second quarter of 2015.

Going forward, DuCharme says that Russell Investments will work with its clients, and their objectives and constraints, to provide them with solutions as cheaply as possible. "If they are still interested in the WM rate we want to provide it as inexpensively and easily as possible. Depending on

Michael DuCharme

their objectives and what their clients want them to do, we will provide them with the tools they need. Time will tell whether the focus will move away from the 'five-minute' methodology and the volatility that it brings," he adds.

Trading platforms are providing greater liquidity and more liquidity providers, as well as time-stamping, so that transaction cost analysis can be undertaken. DuCharme says: "The absence of transaction cost analysis in the FX market has been a crucial issue and this is changing now with many firms offering it or investors doing it for themselves. Things are changing for the better, but there is a lot of uncertainty and investors are having to grapple with this."

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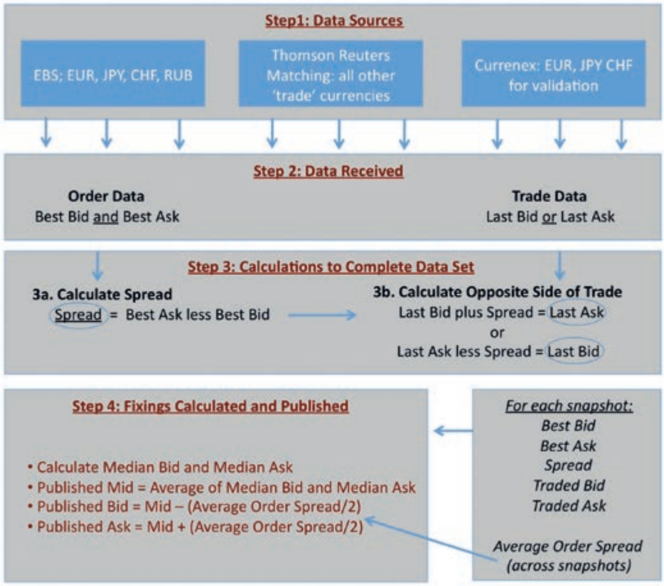
ALGORITHMIC SOLUTIONS

DuCharme believes the tools are now available to instigate this change with the growing use of algorithms for trading over a period of time and the provision of a time weighted average price to provide a better benchmark to institutional investors. He says: "Technology is making these tools available to a wider range of users and this is a positive move. With the tools that calculate what the actual cost to trade is, we can compare trading outcomes to a benchmark and use that feedback to enhance future trading. One doesn't have to trade at a point in time to demonstrate best execution. There are other ways to trade cost-effectively and efficiently and then use transaction cost analysis to evaluate costs and trading strategies and adjust those strategies as necessary."



Source: FX Benchmark Group/ FSB

Spot "Trade" Currencies Process

WM utilises data from three transaction systems and uses four key data points to publish the fixing rates - best bid, best ask, last traded bid, and last traded ask.

Founded in 2009, Barracuda FX specialises in the design and development of trading and risk management software solutions for the global banking industry, providing FX order management, liquidity and execution management capabilities to cater for the needs of banks' FX sales and trading functions.

Kieran Fitzpatrick, CEO of Barracuda FX, says the use of the Fix grew up around the need for a standard published FX rate for portfolio managers who needed a rate to value their international portfolios in a consistent manner to their peers, thus minimising the tracking error.

He says: "It was good for this purpose. It started as an information source rather than a trading benchmark but before long significant volumes were traded on it. The benefit to the buy-side was that it was largely risk free. They could trade at that Fix and in most parts be guaranteed the mid-price of that rate. The scrutiny that the Fix has recently come under is hugely beneficial to the industry as there is now a much greater awareness amongst its consumers as to its appropriateness and whether they were actually getting best execution.

Much of the problem came down to that fact that FX was not the primary driver for the main users of the Fix; it was the rebalancing of their equity or other portfolios. Now, with a much greater awareness of its pros and cons, participants are reviewing whether they will continue to use it. While some are already using or considering alternatives, it is expected many will continue to use it in the near and medium term as that is what their mandates dictate. "It will continue to be used as it is built into many of the processes and downstream investment management systems and provides benefits in terms of the tracking and auditing. Even if fund managers want to get their mandates and agreements changed at board level, this will take time."

According to Fitzpatrick, the recent consultation and recommendations from the Financial Stability Board have highlighted the concentration risk, price movement and volatility around the Fix and are already prompting greater use of alternative approaches such as algorithmic execution – ranging from simple time or volume weighted average price algos to more complex algorithms provided by a number of banks. He says: "The challenge for the consumers of these algorithms is being able to measure the execution quality of either a new benchmark or algo execution across the various vendors and across times. There will be ways to make the move to algorithmic execution more accessible and it will come wrapped with much greater independent transaction cost analysis."

Kieran Fitzpatrick

"The increased awareness is two-sided: the buy-side is more aware that the Fix may not be the most appropriate way to price portfolios but equally they accept, that as a mechanism, giving all this risk to a bank and asking them to price it for free isn't equitable."

CONTROLS AND COMPLIANCE

Banks managing the benchmark must demonstrate that they have the appropriate controls and compliance in place. To enable this, the Barracuda FX platform facilitates the automation of the Fixing process and provides banks with the compliance controls and audit trails to offer benchmarking in a completely controlled and efficient environment – one of the FSB recommendations focused upon the need to improve the transparency and the visibility of the Fixes. With the recent widening of the Fixing window, banks have responded by moving away from the mid-price to at least a bid/offer price or a brokerage/transaction fee.

Says Fitzpatrick: "The increased awareness is two-sided: the buy-side is more aware that the Fix may not be the most appropriate way to price portfolios but equally they accept, that as a mechanism, giving all this risk to a bank and asking them to price it for free isn't equitable." The Barracuda platform enables banks to automate this spread management and provide consistent mark-ups. In addition, the Order Management System allows those regional banks that do not want to price it themselves to effectively outsource their benchmarks to those banks that will. This allows them to maintain the client relationship while the market risk around the benchmark will flow to the banks that wish to take it. Fitzpatrick adds: "We are dealing with a number of banks that want to pass WM Fix requests from their clients to another bank. They still want to be able to offer the service but not take the market risk."

While Barracuda has grown around providing greater automation around the order management of the Fix, it is also seeing greater demand for its wider OMS capability - supplying the banks, and some very large corporates, with the most efficient order management solutions - the mechanisms for execution of different order types in a controlled way, improving the accessibility of bank algorithms to the buy-side and enabling smaller banks to run those algorithms for hedging and risk management.

With the recent scrutiny of how benchmark fixing orders are managed, it has become

Just because everyone else does it does not satisfy any known or credible fiduciary standard.

more apparent that the easiest and most cost-effective way to handle these and other FX orders is through the right technology. And it is systems like Barracuda that can deliver automation, control and transparency that will ultimately help both banks and buy-side consumers to more efficient order management.

PERCEIVED BENEFITS

Independently owned and headquartered in New York, Cürex Group is a financial technology solutions provider whose business objective is to provide fairness and transparency to users of foreign exchange, whether they are institutions, corporations or investors, by working in partnership with clients to create more efficient foreign exchange investment structures and to lower transaction costs.

James Singleton, chairman & CEO of Cürex Group agrees with Lowry that it is all down to the perception of the benefits. He says: "The fundamental, perceived benefit of an execution at the Fix is that the market participant gets the same price as every other market participant in the Fix process. And at that, a price that is the midpoint, without any transaction cost. Of course, the issue here is the 'perception'. The idea that there is no transaction fee charged for a Fix execution misses the concept of real cost. There is of course an 'economic' price paid by all users of the Fix – investigations and fines have documented that. Furthermore, holding an FX risk position during the day to wait for the 4pm Fix is more likely than not to have its own economic (P&L) cost."

Over many years, the Fix has become much more than it was intended to be when it was first conceived. Singleton says the evolution of the Fix has led to today's situation where a 'clearing price' has to be determined at a point in time to handle a large order book for every tradable currency. He says: "As the Fixing has grown bigger, its limitations have grown more obvious. The conventional thinking that execution at the Fix addresses the concept of best execution is seriously flawed – "just because everyone else does it" does not satisfy any known or credible fiduciary standard."

But he adds, perhaps the most glaring issue is the serious valuation mismatch that occurs every day when some non-GMT market closes and uses the 4pm London Fix to determine its value. "How any investor puts up with that standard of benchmarking is frankly hard to explain. Again, just because 'everyone does it,' does not negate the need for benchmarks in the FX marketplace that address the practical needs of all market participants," Singleton says.

Singleton believes that investment professionals continue to use Fix rates because they do not think they have an alternative and simply because they have become used to using the convention of the Fix rate. For these reasons they have proven themselves to be reluctant to assume a leadership role and initiate fundamental change to the status quo even if the prevalent practices are unsatisfactory, inexact or just plain flawed.

Jamie Singleton

"The idea that there is no transaction fee charged for a Fix execution misses the concept of real cost. There is of course an 'economic' price paid by all users of the Fix..."

Further, he believes the market does not need to transition to regional standards as that could lead to negative outcomes. He says: "The FX market is dynamic over its 24 hour period of activity. Any point in time auction will attract whatever liquidity is present. This lumpy approach presents the same possible problems that the 4pm Fix encountered." In the equity market, a constant, streaming auction is occurring and when trading equities on exchange, there is no need to stop the clock to determine the price of a stock or corral buyers and sellers to promote liquidity.

Even though the currency market is global and highly fragmented, Singleton believes it does not mean that such an exchange-like environment cannot be created for FX execution; it just takes rules, transparency and fairness. Such FX exchanges could exist in any time zone that supports that activity. He says: "FX market participants need to trade risk at every millisecond of every day, so how does constraining them to specific points in time advance their risk management practices? There is plenty of market intelligence to measure liquidity, assess counterparty performance and market volatility. Smart data analytics developers are creating predictive artificial intelligence to facilitate those risk management functions."

INDEX BENCHMARK

Cürex operates an anonymous electronic trading platform with no last look liquidity, and every execution on its ECN is a print at the FTSE Cürex FX Index benchmark rate. Cürex began building a technology platform for the buy-side five years ago. Singleton says: "We recognised the emergence of execution regret arising from the FX market's opaque nature and the lack of best execution alternatives. Having the ability to execute at a benchmark rate that is derived from a live, streaming multi-participant liquidity pool with strict rules that enforce democratic and fair treatment is a choice that was not available until we introduced it to the marketplace in October 2013. Today, there is no reason for any manager to execute FX with regret. There is an alternative: Cürex, and other platforms that purport to deliver transparency or low cost execution. The important difference that Cürex offers is that none of those alternatives also deliver a benchmark execution and carry with it FTSE's oversight, high standards and audit capability."

In July 2012, Cürex, in partnership with FTSE, introduced the FTSE Cürex FX

Index. The indices are live, streaming and executable. FTSE publishes over 2000 indices on a real time basis that cover all 23 deliverable currencies as well as a number of baskets. Each currency pair includes bid and offer indices as well as carry and total return indices. However, excluding the FTSE Cürex effort, Singleton believes not much new has been done in the FX index space because there is little commercial benefit to the index publisher, especially given the entrenched nature of WMR. “At Cürex, we were not burdened by legacy convention. That freedom allowed us to collaborate with FTSE to introduce a radically different approach to benchmarking that looked and felt like the standard used in the equity markets.”

A benchmark should be judged by its rigorous rule set and methodology

Singleton believes a benchmark should be judged by its rigorous rule set and methodology and its sustainability. A benchmark, particularly in the FX marketplace, can never represent a global, aggregated best price at any millisecond, this, he believes, is impossible - even off-market trading in the equity world delivers different execution prices than those observed on the exchanges at any moment.

To Singleton, the point of the benchmark is to present a value which is fair, market-driven and available to all. When consistently overseen by a set of publicly available rules and supported by a broad representation of the market’s available liquidity, such a benchmark should be embraced by the market’s participants – especially given the obvious lack of relevance of existing, tired, legacy alternatives. “At Cürex, we believe that the benchmarks we have built with FTSE provide the real time relevance that the FX market needs today,” he adds.

While there are a number of initiatives in the marketplace to provide independent Fix execution and netting, Debelle said in his speech in Sydney there has yet to be significant progress in terms of the pricing and execution of the Fix business within institutions. He said: “On pricing, while there may be more than one way of charging for the fix business that could be adopted, there needs to be a widespread adoption across the industry. On the separation of the Fixing business, the primary objective is separation of the information flow. There are, again, a number of potential solutions to this and I accept there may be some scope to provide more guidance around this recommendation, particularly in the case of less-traded currencies.”

He concluded his address with a warning that while there is a strong expectation that the FSB-approved recommendations will be implemented to deliver an improvement in the execution of foreign exchange transactions referencing FX benchmarks and the integrity of the benchmarks themselves, if they are not, the likelihood of a regulatory response will increase.