What You Don’t Know Can Hurt You: Trading in Non-Transparent FX Markets

Growth Leaders

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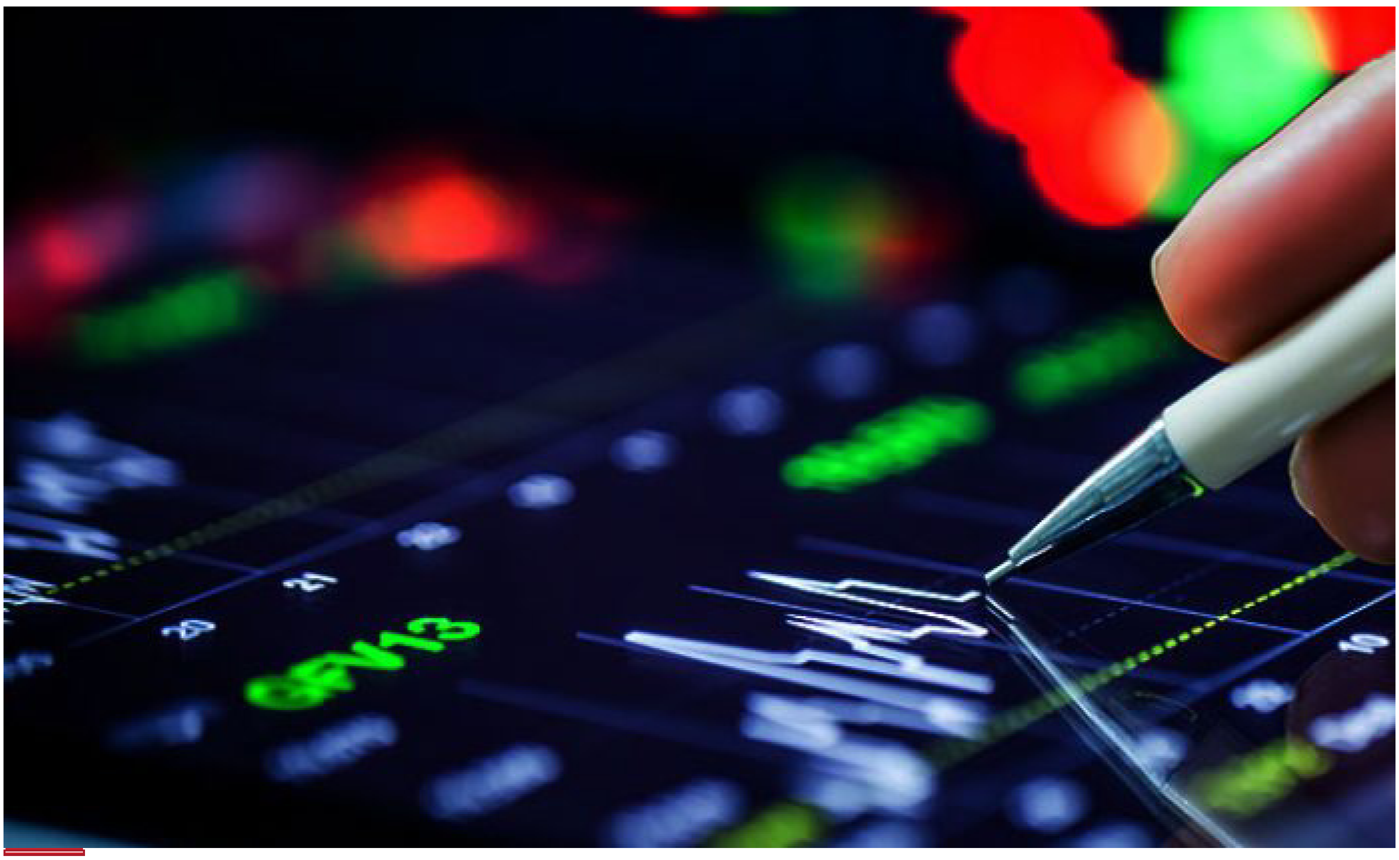

Why Trading in Non-Transparent FX Markets is a Bigger Risk Than You May Realize

In the post Sarbanes Oxley and Dodd Frank world, CEOs have a lot on their minds. From conflict minerals disclosure to financial statement certification, regulations have buried corporate financial and legal departments with ever increasing requirements. And macro trends like increased disclosure do not usually reverse course. It is inevitable that greater scrutiny will be focused on even more elements of corporate management and operating activity. Given that burden and its obvious real economic cost, one might wonder why I would bring up the topic of foreign exchange trading and the associated economic and compliance risks. After all, CEOs have a department to deal with that largely administrative function, right? Well, in this case what you don't know may actually be costing you a lot.

A Few Background Basics

To begin with, the FX marketplace is highly fragmented, immense and has existed as one of the least transparent of the capital markets. The market itself runs 24 hours a day, five days a week across every geographic time zone. With a daily average volume of over $5 trillion in the aggregate, the FX market has no consolidated tape and no central portal for price discovery. The real operational users of FX – corporations, asset owners and asset managers – face this opaque market on a daily basis to make cross border payments, purchase foreign securities and settle trade. To accomplish their transactional needs, these operational users of FX have relied on long-standing, traditional methods to execute their FX trades.

To trade FX, every market participant needs credit, which they receive from their banking relationships. Fifteen years ago, 78% of all trading activity was executed using the phone. Given the bilateral nature of the marketplace and without a technological way for the corporate user of FX to check market prices, FX orders were communicated to one or more banks or brokers and those orders were filled at prices which suited the price maker. In that environment, the corporate user of FX had no recourse but to accept the price delivered to them by their bank or through their representative broker.

Technology Evolution

Over the last 15 years, new technologies have been introduced to improve the functional operations of the FX marketplace. Customers have in large part abandoned the phone as their FX order mechanism in favor of computer based solutions. An increasing number of corporations and asset managers have engaged execution management systems (EMSs) to manage their trades by connecting them to all their credit relationships through the use of one computer based interface. The introduction of EMSs and other technical improvements have propelled the FX market to higher daily trading volumes as speculators and high frequency traders (HFTs) have rapidly expanded their footprint to take advantage of a more efficient and consolidated trading market, where speed and knowledge of order flow creates an enormous advantage for their profit making motives. For the corporate user of FX, these new technologies have streamlined their ability to manage their credit relationships. These technologies also vastly improved their middle and back office functions, providing automated record keeping and trade related services. But the one thing that these technologies have failed to do is to make the FX marketplace less opaque.

The Impact of Enforcement and Regulation

Over the last few years, the inevitable happened to this large, mostly unregulated capital market – first, whistleblowers stepped forward to implicate the execution practices of certain custodian banks. As damage was measured and settlements negotiated, the next shoe dropped – a price manipulation scandal involving the FX marketplace's primary benchmark, the WMR Fix. The world took notice, including every major central bank. Committees were formed globally and as enforcement extracted monetary payments, regulatory bodies got involved. In just the last two years, bodies of work like the Fair and Effective Markets Review, published by the FCA and Bank of England, the FX Global Code of Conduct, an evolving set of market standards being developed by central banks and market participants, and the European Union's MiFID II have been rolled out to address the market's long standing issues.

And like markets do, the FX market has begun to change – accepting that the lack of transparency in the marketplace has to give way to more fairness and equal treatment for all FX users. The winners in this cycle of change will be the corporate users of FX and the asset management community. But this benefit is not just going to land in their laps. They will need to embrace the changes and improvements now available and abandon the habits they have gotten used to when executing FX trades. And like all change, there will be a cost to adapt in the short run that will ultimately lead to benefits in the future.

What's the Economic Impact to Corporations Executing in Non-Transparent FX Markets?

The critical problem with non-transparent markets is the economic cost that the corporate FX user suffers because the lack of transparency negates the opportunity for best execution outcomes. When approaching an opaque market to trade, the corporate FX user is handicapped by the absence of pre-market analysis, which would otherwise inform their trading decisions. Knowing the market's condition before making a trading decision is by definition impossible in an opaque market. And after a trade is executed in an opaque market, the corporate user of FX has no context to assess the performance of that trade since he or she has no basis to analyze the market conditions and dynamics that existed at the time the FX trade occurred. This lack of information access has an economic cost, and the transaction cost analysis that we have performed for numerous corporations and financial institutions has proven the point dramatically.

Price discovery and pre- and post-trade market intelligence should be every corporate FX user's right. Many corporate treasurers believe that when they approach the market using a request for quote (RFQ), they are running a small auction that allows them to obtain a best price execution. But there are critical problems with this trading practice. First, the existence of RFQ's does little to address the opaque market condition. Second, when a corporation declares its trading intention – size and side of trade – as well as its identity, that corporation actually negatively impacts its own execution. The institutions who have been invited to quote are all market makers, who are within their commercial rights to take that RFQ information and use it for their own benefit. While recent bank settlements and disclosures have made that practice better understood, the RFQ approach to execution remains a prevalent market practice. To achieve a benefit for the corporate FX user, the roles in this execution scenario should actually be reversed. The corporation should be completely anonymous; the market liquidity should already be streaming and available (as opposed to requested on demand); and the price makers' market view (their bids and offers by execution size) should be transparent and executable (not subject to "last look" – the ability of the trading counterparty to reject an agreed upon trade within a brief window of time). The odds of achieving a best execution outcome in a non-transparent market lacking these characteristics is in the realm of slim to none.

Do Corporates Have a Compliance Exposure to FX Trading?

The simple answer is no – not a direct disclosure issue as it relates to their spot FX executions. But U.S. and multi-national corporations do have to comply with a number of accounting standards under U.S. GAAP, such as FAS 133 and 52, and under IFRS, such as IAC 21 and 29, which together relate to the use of derivatives, hedging and reporting. At the core of these standards is a reliance on "fair" FX values. In the past, because of the non-transparent nature of the FX marketplace, a financial department could effectively "choose" an FX rate that broadly represented a market rate for their reporting purposes. As the saying goes, in the land of the blind, the one-eyed man is king. In the increasingly transparent FX world, the issue of what FX rate to use and where that rate is sourced is likely to be a question raised by outside auditors. The bottom line is that corporate FX users should pursue transparency. The good news for corporates is that financial institutions participating in the FX markets will be on the front line of this and other compliance requirements. Their embrace of transparency will drive benefits for all operational users of FX, including corporations.

Choosing a Lane to Achieve Cost Savings Through Best Execution

Enforcement actions and compliance are driving more choice in execution alternatives for FX market participants. Banks themselves have built algorithmic agency execution platforms that allow their customers to execute FX trades at third party venues using the bank's credit and order management processes. FX ECNs are also building liquidity pools that offer no last look, executable liquidity. One thing is for sure: the regulatory prescription for transparent best execution and FX operational users' need for compliance and fairness are moving the FX market inevitably into the bright light of transparency.

While the macro trend toward transparency is inevitable, the question remains when will the market's participants embrace change? There is no doubt that corporate users of FX have a tremendous economic benefit to gain from taking complete control of their FX executions and pursuing best execution outcomes. Those that embrace change will achieve cost savings sooner than those who wait on inevitability. What you do know should benefit you. Better FX execution is a long overdue opportunity to save money – plain and simple – and the options to do so are available today.