

# TREASURY & RISK

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## Light Up Your FX Markets

Why transparency in currency trading is a must-have for corporate treasurers and risk managers.

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**F**or decades, corporate treasurers transacting in the foreign exchange (FX) markets have been feeling their way through the dark.

We're all familiar with the hazards inherent in making our way across an unlit room. When the lights are off, the furniture, floor lamps, and area rugs all seem intent on tripping us, no matter how hard we try to avoid them. Navigating with zero visibility is uncomfortable.

For corporate treasurers who need to make cross-border payments, purchase foreign securities, and/or settle international trade, using an opaque FX platform presents the same risk of getting tripped up that a dark room might present. The global FX marketplace is both immense and highly fragmented. Trades occur 24 hours a day, five days a week, across every time zone. Yet, despite a daily average volume of more than US\$5 trillion in the aggregate, FX markets are among the least "lit" of the capital markets.

Unlike the equity markets, the FX markets have no central portal for price discovery and no consolidated tape to inform the broader market of the value of the securities or instruments being traded at any point in time. In the equity markets, the consolidated tape reports every purchase and sale of every security, providing transparency. Because the FX markets are so enormous, global, and open 24 hours a day, an FX consolidated tape is not practical or realistic, but its absence contributes to the opaque nature of that marketplace.

By their nature, FX trades are mostly one-off, bilateral transactions in which operational users of FX—corporations, asset owners, and asset managers—tap their banking partners for the credit they need to conduct their desired foreign-currency transactions as well as for the execution of the transactions. As recently as 15 years ago, the vast majority of these transactions occurred via the phone or fax. Without a technological means for checking market prices, institutions and corporations needing to transact FX gave their orders to one or more banks or brokers, then received order fills that may or may not have represented the best, or most reasonable, prices available.

Nowhere was accurate aggregated data available on the overall transaction pricing or volume in the market. Operational users of FX had no recourse but to accept the prices delivered by their banks or representative brokers. In essence, the lights were off.

### Enlightenment Coming Slowly to FX Market

Then, about a decade ago, a new generation of technology was born. Instead of using the phone to place an order, operational FX users could turn to an order management system (OMS) or an execution management system (EMS), which could not only manage trades but also—equally relevant—allocate a trade across multiple internal accounts and provide for entry into forward positions, if desired.

These improvements propelled FX forward. For the operational user of FX, they streamlined management of banking and



custodian relationships. They also vastly improved operational users' middle- and back-office functions, providing automated recordkeeping and trade-related services. At the same time, though, they encouraged the emergence of speculators and high-frequency traders (HFTs) who could take advantage of a more efficient and consolidated marketplace where speed and knowledge of order flow

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created an enormous advantage.

Ultimately, the new technologies did not make the FX marketplace more transparent. In fact, the spread of these technologies might have created an even more opaque marketplace. In the simpler Dark Ages, the bilateral market

practice was heads up. The price maker and price taker had a conversation and came to a pricing agreement. The price maker made an undisclosed amount of profit, in return for taking the risk inherent in establishing the position. But those expected profits could potentially turn into losses; although the banks might have been playing with the house advantage, during the FX Dark Ages, both sides of a transaction were more or less in the dark.

As the technology of the FX Renaissance emerged, that dynamic shifted. While some parties—primarily operational users of FX—remained in the dark, others came into the light. A new host of HFTs arose to arbitrage the inefficiencies that were now present in a market that was growing dramatically in size, and operational users remained the richest profit target for the price makers.

Despite this marginal result of the Renaissance, the inevitable eventually began to happen in this large, mostly unregulated capital market. Whistleblowers stepped forward to implicate the execution practices of certain custodian banks. And as damage was being measured and settle-

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ments negotiated, the next shoe dropped: a price manipulation scandal involving the FX marketplace’s primary benchmark, the WMR Fix. All at once, every spotlight seemed to be trained on the still-dark recesses of the FX marketplace.

The FX pricing and manipulation scandals were big. Every major nation’s central bank took notice. Committees were formed globally, and as enforcement extracted monetary payments from the perpetrators, regulatory bodies put their hands on all the light switches. 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 MiFID II have been rolled out to address the market’s long-standing issues.

As a result, the FX market has begun to change—as markets do. The dark elements of the marketplace have begun to give way to more light, to more transparency, and ultimately to more fairness and equal treatment. The winners in this cycle of change will be the operational users of FX. 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 their bad habits around FX trade execution. And as with all change, adapting in the short run will incur a cost, in exchange for expectations of benefits to be achieved in the future.

### What’s the Problem with Opaque Markets?

Certain market participants will argue that dark pools—which protect participant identity and deny broad participant access—create benefits to FX users who have access to them. My interest is not in arguing about a small market subset. A dark pool by itself does not present a broad market solution for the vast number of operational FX users.

The real problem with opaque markets is the economic cost that FX users suffer because the lack of transparency negates the opportunity for market participants to achieve the best possible execution outcomes. When approaching a trade in the opaque market, the operational FX user is unable to complete the market analysis that it would otherwise use to inform its trading decisions.

There are a few obvious examples of the cost impact of trading FX without access to market intelligence. At the most basic level, operational users of FX must understand that when they select a bank to act as their counterparty in an FX trade, that bank is not naturally acting as their agent, and it has no obligation to offer the best execution available at the time of the trade. In just the last year, almost every large FX-dealing bank has had to disclose this reality in the context of their market-making activity. In the simplest of terms, when an operational user of FX discloses its intent to trade to a counterparty, it may pay a price for disclosing that intention. Since that operational user has no access to relevant and accurate market information, it has no basis to negotiate a better rate with its counterparty. Knowing

that, one can see that the counterparty may fade its pricing to maximize its trading profit.

Moreover, after a trade is executed on an opaque market, operational users of FX have no context in which to assess the performance of that trade, since they have no basis for analyzing the market conditions and dynamics that existed at the time the trade occurred. This lack of information access has an economic cost, and the transaction cost analyses that my company has performed for numerous buy-side institutions has proven the point.

Our findings in these analyses have been quite consistent: When large asset managers trade FX without access to market intelligence, they pay a higher price compared with our benchmark. This is especially true, and a consistent finding, for trade sizes greater than \$25 million and in non-G-10 currencies. That said, we have also found significant cost impacts in very large trades of G-10 currencies that are “worked” by financial institutions on behalf of their clients. The lack of market intelligence prohibits the operational user of FX from assessing the market’s condition and health in advance of these trades.

Every FX user should have a right to price discovery, as well as pre- and post-trade market intelligence.

Even when operational users of FX approach the market using a request for quote (RFQ), there is a danger that the result of this process will not yield

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the best possible price outcome. Many FX users believe an RFQ is a small auction that “lights up” the market, allowing them to obtain the best possible price execution. But there are problems with this trading practice as well. First, the existence of an RFQ does little to address the opaque market condition. Second, when an operational user of FX declares its trading intention, in terms of both its identity and the size and side of trade, that disclosure can actually negatively

impact the trade's execution from the perspective of the RFQ issuer.

The institutions that are invited to quote are all market makers, and they would be within their commercial rights to use information from a customer's RFQ for their own benefit. As previously noted, recent bank settlements and disclosures have made that practice better understood; still, the RFQ approach to execution remains prevalent.

To achieve a benefit for the operational user of FX, the roles in the execution scenario need to be reversed. The customer should be completely anonymous; market liquidity data should be streaming and always available, as opposed to available 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." In an opaque market lacking these characteristics, the odds of achieving a best-possible execution outcome is in the realm of slim to none.

### Light at the End of the Tunnel

The good news is that interest in transparent FX markets is building, as a result of both customer demand and the previously mentioned regulatory actions and edicts. Customers need transparency for intensifying compliance reasons. The litigation threat stemming from whistleblower payouts is also motivating asset managers to take a much closer look at how they fulfill their fiduciary requirements when transacting in the FX marketplace.

As the saying goes, necessity is the mother of invention, and so more choice is entering the FX market to allow customers different execution alternatives. Banks themselves have built algorithmic agency execution platforms that enable their customers to execute FX trades at third-party venues using the bank's credit and order management processes. The purpose of these agency algorithmic platforms is to give the operational user of FX more choice regarding their execution style and preference. Essentially, the operational user of FX chooses a bank provider to act as an agent on its behalf. That user is then entitled to choose among a variety of different algorithmic executions that range from completely passive to intelligent.

Importantly, when the operational user chooses to execute its FX using these platforms, its identity is protected from the ultimate counterparty to its trades. This anonymity is a step forward in the process of achieving a best execution outcome. In addition, these algorithms naturally slice and dice the original trade size. This fragmenting of an order creates less market impact, particularly for large executions. Avoiding market impact maximizes favorable price achievement.

FX electronic communications networks (ECNs) are also building liquidity pools that offer no-last-look, executable liquidity. An ECN is a virtual marketplace, like the New York Stock Exchange or NASDAQ. ECNs are electronic venues where market makers offer two-way pricing (bids and offers) and where clients are permissioned through the credit that they have with their bank(s) to access the pricing being offered by those market makers.

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The advantage of ECNs is that they bring multiple market makers to one place, promoting pricing competition. These pools are often fully transparent, but they may or may not protect customer identity. An operational user of FX who does not use an ECN limits itself in terms of trading choice, forgoing the advances that can contribute to better trading outcomes.

ECNs that offer no "last look" are particularly attractive to the operational user of FX. "Last look" is a term that describes a counterparty's right to reject a matched trade within a defined period of time (usually less than 250 milliseconds) if it determines, in its sole discretion, that the trade is not profitable. The cost of "last look" can be significant to operational users of FX, particularly when a market is moving against them.

One thing is for sure: The regulatory prescription for transparent best execution, along with FX operational users' need for compliance and fairness, is

slowly moving the FX market toward the light and away from its opaque history. This transition is inevitable, but the question remains: When will the market finally change? Operational users of FX should take the preliminary steps to explore the benefits of more sophisticated FX trading alternatives like bank agency algorithmic platforms and ECNs. Depending on your needs and the size of FX trading activity, both of these options may be effective alternatives for delivering lower all-in execution costs. A good way to measure the potential benefit is to analyze a selection of historical FX trades against a reliable benchmark to determine the cost of your current FX trading practice.

There is no doubt that the operational users of FX are beginning to avail themselves of solutions that better enable them to navigate their walk across the dark room that represents the opaque FX marketplace. The good news for treasurers and risk managers is that there are readily available alternatives to the opaque and costly FX executions that have been the norm for many years. The early movers will achieve best execution outcomes and cost savings sooner than those who wait on inevitability. A good place to start this cost-saving exercise is by launching a conversation with your individual banks, with a provider of transaction cost analysis, or with an ECN provider. The FX market is adapting rapidly; keeping your knowledge base current will be illuminating.

Lighting up the FX market is a good thing, and the time has come.



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