New Strategies to Cope with the FX Liquidity Crunch

Following the recent rise in the number of non-bank market-makers in FX, which brings in a new community to the marketplace, it seems counter-intuitive to claim that there is a crisis brewing in terms of a liquidity shortage; in fact, there are – arguably – more market-making participants than ever before. However, according to buy-side attendees of a recent Global FX Steering Meeting of the Hive Community in London, there was a consistent message that many participants executing relatively small trades (i.e. approximately $5 million) are still making a notable market impact – even in the most liquid pairs such as EUR/USD.

Attendees noted that it is widely recognised that regulatory changes (Volcker Rule and non-Spot balance sheet utilisation) combined with the impact on banks responding to the FX trading probes have had an impact on banks' ability to warehouse risk and internalise flow. This, in turn, has had a constraining effect on their overall ability to participate as market-makers in the FX market. As a result, many traditional liquidity providers have now completely retreated from their traditional role of primary liquidity provision, to the extent that it was suggested by the Hive Community that currently only eight to 12 banks can effectively internalise flow. And while non-bank market-makers have emerged to fill the void – resulting in a significant change in the traditional liquidity landscape – their contribution is not the universal panacea for solving the current liquidity challenges.

Non-bank liquidity

As alluded to previously, the growth of non-bank liquidity appears to be the combined result of regulatory reforms, the macroeconomic environment, the apparent FX benchmark manipulation and structural changes which have been taking place in the FX market in recent years. In the 2013 Bank of International Settlements (BIS) FX Survey, non-bank counterparties were responsible for $2.8 trillion, or 53% of the survey's $5.3 trillion a day total for global FX volumes. In the 2016 Euromoney FX survey, non-bank liquidity providers entered the top 10 for the first time – highlighting their recent and notable impact on the FX landscape.

At the same time, traditional market-makers' lack of ability to internalise flow has fuelled the rise in use of bank agency algo services in order to meet buy-side execution needs and minimise the risk of market impact. This has led to a rise in the popularity of platforms such as FX Connect as a way to ultimately access non-bank liquidity via bank algo execution as well as trade through traditional bilateral Request For Stream (RFS) mechanisms.

Attendees at the forum believed that while algo execution may very well address specific issues, this should be combined with comprehensive transaction cost-analysis (TCA) services. Furthermore, to adequately meet all of the buy-side's best execution needs, algo execution strategies should offer comprehensive transparency around their intended behaviour and their historical performance, including the utilisation of underlying execution venues such as Currenex as well as the historical performance of these specific venues.

Challenges with the alternatives

Although algo execution is certainly gaining prominence as an effective and viable solution for many on the buy-side in response to the liquidity shortage – and with good reason – there are a number of challenges which need to be considered, including:

- The overall signalling and market impact risk;
- The buy side's ability to control the selection of algos and those algos' historical performance, utilisation of execution venues, potentially including the behaviour of those underlying venues;
- The trade lifecycle. Ideally TCA should cover the entire lifecycle, not just at the point-of-trade execution but also when the FX exposure appears in the OMS. Millisecond or even microsecond precision-level information is required and at the moment is generally unavailable from banks' TCA services, which are provided as part of their algo packages. This has pushed many buy-side customers to develop their own in-house solutions, despite the drain on time and resources this creates. Through its integration with third-party TCA tools, FX Connect facilitates this requirement, with many different timestamps to millisecond level built-in.
- The need for TCA to be applied to the forward and swap point elements of outright and swap trades, in addition to the spot point elements. Attendees at the event felt that finding a market standard for reference data for forward and swap points was a challenge and again has driven many institutions to develop their own in-house solutions.

The Credit Conundrum

While non-bank market makers have emerged to fill the void left by having fewer traditional market-makers, non-bank providers do not have forward credit lines. And current balance sheet utilisation requirements mean that there is little appetite among prime brokers to provide this credit. Ultimately, non-bank market-makers currently have only a limited ability to price forwards and outrights. In addition, the stringent balance sheet utilisation requirements could further potentially constrain liquidity, and developments in 2017 are set to compound this situation, particularly in light of the new collateralisation requirements coming into force in March.

More work to be done

In general, from our discussions at the Hive Community Forum there is appetite among buy-side firms to look beyond their traditional bank providers to access the universe of available FX liquidity. But accessing new non-bank liquidity sources is not without its challenges – and more transparency and enhanced analytics would be greatly welcomed to help them make more-informed decisions about their execution needs.

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