The FX derivative markets – does the back-office already have the "nuts & bolts" in place?

Overall, the FX markets performed well during the past crisis. Yet there is room for improvement. Less so on a regulatory level, but rather internally in the back-office of the key industry players. With an update on technology, FX market participants can easily make substantial efficiency gains and lower risk significantly.

As everyone knows, the financial markets are living through momentous times. Regulatory, political and media attention is at its highest. The financial crisis, the squeeze on margins, the need to better manage costs, the use of OTC derivatives, the increasing regulatory pressure, bonus structures and company ethics, and the discussions around market reforms are all subjects that are widely debated in the press.

In particular, widespread and irresponsible use of OTC derivatives has been blamed as being one of the main reasons behind the financial crisis. Legislation is currently being discussed and passed in the United States to bring stringent new regulations to these markets. The European Union is closely following the progress of their US colleagues in order to try and move towards some form of harmonized reform. It is as yet by no means fully clear what the proposed reforms will mean to market participants. Debate continues on the definition of a "major swap participant", possible exemptions for corporations as well as whether FX swaps – common instruments for hedging financial risk – will have to follow the route of mandatory central clearing.

The focus of this regulatory "push" on OTC derivatives seems to be clear: tightening up regulatory control, discouraging speculative trading and introducing efficient mechanisms that can help firms better manage credit and counterparty risk. The debate in political and financial circles so far is correctly focusing on the themes of general risk management and the future avoidance of "systemic" risk, but banks and buy-side firms themselves have not been slow to launch their own market initiatives and have also been closely examining internal procedures with an aim to improving efficiency and reducing and controlling financial, liquidity and counterparty risk.

Much of the focus has been around the treatment of CDS deals and considerable attention has been rightly given to the success of market initiatives such as the use of TriOptima to compress CDS deals and the discussions around a possible centralized Trade Repository for OTC derivatives. But in all this discussion, the question of FX derivatives, the possible need for regulatory intervention and an examination of internal processes has been either postponed or sidelined. The question is of course very delicate, but if we leave aside for a moment the on-going debate between politicians, market participants and regulators on whether or not these instruments should be subject to regulatory controls similar to other OTC derivatives such as CDS, CDOs etc., perhaps we can still examine the question of just how efficiently market participants manage FX derivatives.

How did the FX markets fare during the financial crisis?

Many observers seem to believe that the FX markets and the related FX derivatives markets are already highly efficient markets whose nature (generally short term with high turnover ratios and real physical exchanges of principal) is totally different to that of the other OTC derivatives markets. But how did FX derivatives really fare during the financial crisis?

To begin with, the last triennial report in 2007 from the Bank of International Settlements on OTC derivatives volumes, widely considered by the market to be the most accurate measure of market volume, estimated that of the USD 3.2 trillion daily average turnover in the foreign exchange market in April 2007, more than USD 1.7 trillion, or 53%, comprised FX swaps. The London-based Foreign Exchange Joint Standing Committee (FXJSC), which comprises leading market banks, brokers, industry associations and regulatory bodies, recently estimated that global volumes now exceeded April 2007 levels, and London alone now had total volumes of USD 1,356 billion of which USD 87 billion is traded in FX derivatives (currency swaps and options).

It is generally accepted that compared to other asset classes, the FX market remained fully operational throughout the financial crisis, even if there was a knock-on effect from the money markets on the FX swaps and cross-currency swaps markets as banks turned massively to these markets looking for dollar funding and thus put additional pressure on interest rates.

It is also worth noting the key role played by the CLS Bank, which settles all the main FX products of spot, forwards, swaps and NDFs, during the financial crisis. During the Lehman crisis, there was huge volatility on the FX markets and CLS reached a peak volume of 1.5 million instructions on 17 September 2008. Lehman Bros was one of the top participants in the CLS system and in that week alone CLS processed over USD 150 billion trades where Lehman was a counterpart with no problems on settlement.

But if the FX markets performed so well in a moment of crisis, are there really no areas of improvement?

Areas of improvement

An indication that there are still areas to perfect are the market-borne initiatives, such as those being evaluated by the FXJSC. Several areas of potential risk and "system failure" have been identified. CLS performed well, but CLS does not yet manage all currencies and has 59 direct users and approx. 5,000 indirect users. Efforts are being made to extend coverage and membership. Longer-dated FX trades, such as forwards, FX options or cross-currency swaps possibly still represent an issue in terms of counterparty risk.

Would a Central Counterparty (CCP) clearing mechanism, with all the complications of managing a truly international,

cross-border market that cuts across legal jurisdictions, be a feasible idea? One concrete initiative just launched is the CLS aggregation pre-settlement service, which aggregates low-value FX trades to better manage operational risk and improve post-trade processing efficiency.

Yet despite these initiatives, doubts still remain about the real efficiency in market participants' management of OTC derivatives. The FXJSC in their April 2009 UK turnover survey justly highlights the widespread use of electronic trading platforms and portals for spot transactions, but estimates that 73% of FX swaps, 92% of cross-currency swaps and 87% of FX options are traded bilaterally over the phone or via voice brokers. What does this mean in terms of back office operations if not manual input into various systems with the inherent risk of human error and the natural consequence of settlement problems, broken trades and heightened counterparty risk?

Further evidence on these risks is provided by the ISDA 2009 Operations Benchmarking Survey. ISDA calculates that 51% of errors in currency derivatives are due to the input of incorrect data in the front office that is then passed either manually or electronically to the back office. The same survey reports that only 51% of FX derivatives and 48% of interest rate swaps (that in this survey include cross-currency swaps and FRAs) are confirmed electronically. In general, the survey concludes that, although the level of automation is improving, only 52% of FX derivative volumes and 50% of interest rate derivatives are automated.

What makes this data raise even more questions is that on the basis of BIS statistics, approximately 43% of overall transactions on the Forex markets are interbank, 40% between banks and buy-side firms, and the remaining 17% between banks and corporations, or in other words 57% of FX transactions involve the less automated parts of the industry.

Investments in operations and technology

Despite the quiet confidence that FX markets and its derivatives are efficiently managed, and that strong regulatory intervention is not required, strong evidence suggests that there is still room for considerable improvement in market participants' internal operations.

It is not incidental that in 2009 research from both the Boston-based Aite Group and the Capital Markets Practice at Tower Group reported the need for investments in technology and operations in the FX and OTC derivatives markets. The Aite Group calculated that the cost in the United States for processing an FX ticket can be up to USD 14 compared to USD 0.05 for an equity trade due to inefficient and manual back-office processes.

One of the key themes in discussing efficient back-office operations is the need for flexibility and this can only derive from the use of appropriate software and technology that does not rely on hardcoding but can be flexible enough to adapt to changing market requirements. The technology needs to be open enough to allow the insertion of new functionality, e.g. the requirement to manage collateral in a more efficient fashion, and also to embrace emerging standards such as XML, FpML and XBRL.

Improvements in the operational areas highlighted in this article are by no means beyond the financial reach of the majority of banks and buy-side firms. Companies such as *riskart* have developed systems, technology and the consulting skills that resolve key issues such as accurate deal capture, managing complex FX derivative structures, handling "exceptions", automatic confirmations, settlement instructions, and comply with regulatory standards and reporting requirements.

Paraphrasing Albert Einstein, investing in the "nuts and bolts" means that "everything is made as simple as possible, but not simpler". The conclusion is that – regulatory intervention aside – the market can still take significant strides to ensure that the back office contributes decisively to an even more efficient and risk-free management of the FX markets.

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