FX Markets

Swaps platform aims to cut out the banks – but not entirely

Peer-to-peer newcomer FX HedgePool targets asset managers' month-end hedging activity

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06 Aug 2020

NEED TO KNOW

- Asset managers trade billions in FX swaps every month to hedge currency exposure from index-tracking funds.
- A new platform is offering to match some of this activity and save clients paying a spread to banks.
- Banks are still involved, though, by taking on the credit risk of trades. They receive a fee in return.
- Asset managers are interested, and the service already claims to be matching billions in swaps every month.
- But doubts over credit capacity could limit the platform's success.

Banks would be forgiven for greeting news of another entrant in peer-to-peer foreign exchange trading with a weary eye-roll.

The newcomers arrive with promises of big savings for participants by matching up trade flow and chopping out the middleman, namely banks. But sooner or later they fade away, having failed to achieve a critical mass of clients.

FX HedgePool is the latest peer-to-peer hopeful seeking to challenge the status quo. Unlike many of its predecessors, though, it isn't seeking to disintermediate banks. Rather, its business model requires dealers to take the credit risk of trades, for which they receive a spread.

The company is targeting a segment of the market traditionally viewed as safe and predictable; boring, even. It hopes to free up asset managers from the drudgery of their month-end swap hedging rolls, and save them money in the process.

"Rolling passive hedges is error prone and time-consuming, making it costly to manage in many ways," says Jay Moore, founder and chief executive at FX HedgePool.

The proposition was enough to convince investment giant Vanguard to sign up to the platform in January for the first live run, alongside Eaton Vance and another unnamed European asset manager.

The prospect of cost savings has piqued the interest of others.

"Minimisation of transaction costs for clients is a very high priority," says James Binny, global head of currency at State Street Global Advisors. "In theory removing a middleman has the ability to reduce those costs."

The industry's cost-cutting drive is a consequence of the growth of index tracker funds with their wafer-thin fees. Asset managers are also under pressure to demonstrate they are getting the best deal for end-investors under European regulations.

As a result, some asset managers are exploring alternative sources of liquidity beyond their regular relationships. And fintech firms are only too happy to oblige by creating venues where buy-siders and corporates can offset their currency flows against each other.

Supporters of FX HedgePool say the platform can limit market impact from pre-hedging by dealers. Clients can also reduce tracking error from a mismatch between the trading date and the index roll date.

The service is in its infancy, though, and asset managers may quickly butt up against the credit limits of a small pool of dealers. A lack of offsetting trades may also force participants to resort to the open market for some of their swaps and forwards activity.

For dealers, the service provides both a threat and an opportunity. Senior bankers say they welcome the idea of innovation in the sector. But some are sceptical of the value that the platform provides. Tellingly, bank traders are wary of voicing their concerns publicly for fear of offending clients that may have shown in interest in FX HedgePool.

“If you look at what you gain in terms of bid/offer in the swaps market specifically, I’m not convinced on what that actually provides to the market,” says the head of FX trading at one European bank.

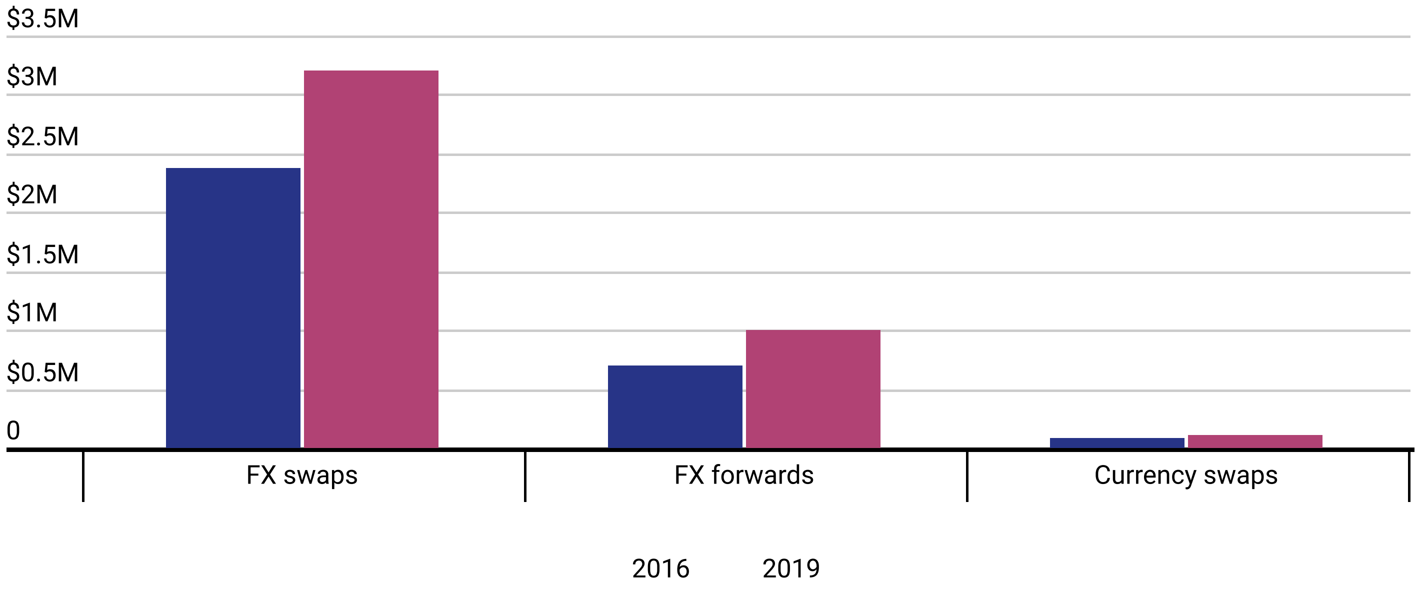
The power of passive

Unlike banks that trade currencies to make a profit, buy-side managers typically trade FX as a by-product of their clients’ underlying investments. Index-tracking asset managers, in particular, rely on FX swaps to avoid tracking errors arising from currency movements in their portfolios, tweaking and rolling them over **each month** to coincide with index updates.

Index-tracking funds are part of the huge and growing passive investment industry, which now accounts for 41% of US open-ended mutual funds and exchange-traded fund assets under management. The share of passive funds is up from 3% in 1995 and 14% in 2005, according to **research** from the Federal Reserve Bank of Boston.

Growth in this segment has contributed to a rise in the use of FX swaps by asset managers. The instrument now accounts for almost half of the market's $6.6 trillion in daily turnover, according to the Bank for International Settlements.

1. FX swaps and forwards



Source: BIS Triennial Survey

Share

The rise of passive investment strategies has slashed the fees that asset managers can earn. With earnings squeezed, investment firms are looking to technology to help **cut costs**.

The sector's new-found frugality has placed a greater emphasis on best execution, where traders attempt to achieve the optimum result for their clients. Often that requires finding the tightest price, but it may also involve fees paid to a broker or venue and the likelihood of execution.

In Europe, the second Markets in Financial Instruments Directive requires buy-side firms to be able to show their clients how they achieved best execution. Part of the law's purpose is to sweep away the cosy relationships between managers and dealers that may have clouded investment decisions previously.

"Buy-side firms are being held to a higher standard, and so they are really trying to manage those transaction costs," says Joseph Hoffman, chief executive officer in the currency management group at Mesirow Financial.

As asset managers' FX swap requirements continue to rise, credit lines at their dealers can become stretched. **Earlier this year**, Andy Maack, Vanguard's global head of FX, said dealer banks are unable to face the firm either because of temporarily filled credit lines or an unwillingness to take on large swap trades that eat up balance sheets but offer little in return.

FX HedgePool sets out to solve some of these cost and credit problems. Its matching platform brings together asset managers that have regular and predictable FX swap activity at the end of every month, coinciding with the roll of underlying indexes.

For example, an asset manager may have $1 billion of one-month EUR/USD swaps to buy every month, and if a second manager had the opposite to do, they can match off at the WM/Reuters fix, the standard benchmark. If the second manager only had $500 million to do, the first manager can match that portion off and then find another counterparty on the platform for the remaining amount, or take it into the open market.

Matching in this way allows asset managers to avoid banks' bid/offer spreads, which can be more than 0.50 basis points per roll in some cases.

The service doesn't come for free, naturally. FX HedgePool members pay a fee, which is split into two parts: a platform fee paid to FX HedgePool and a credit fee paid to a member bank that takes on the credit risk of the trade. Moore says that clients generally pay 0.20bp per trade, "or better".

When clients need to access markets quickly and transfer risk, they tend to go to their partner banks. How would [peer-to-peer] work in a situation like we just had? I think it would be problematic

Head of FX at a European bank

A further benefit comes from avoiding market impact. The FX swaps and forwards market is the preserve of a small number of dealers. According to Moore, the lack of competition means dealers often pre-hedge themselves ahead of month-end rolls expecting to receive the swaps and forwards flows, which can move prices against asset managers. If some or all of that flow is instead matched off on a peer-to-peer platform, less ends up with the dealers, and over time that pre-hedging impact is reduced.

In addition, FX HedgePool argues that the platform helps reduce tracking error. Asset managers generally try to renew their trades as close to the benchmark's roll date as possible, typically at month-end, to reduce tracking errors.

If liquidity is not available at that point, firms might look to roll **early**. In March and June this year, for instance, dealers were encouraging buy-side firms to go early to avoid a liquidity squeeze. This means the rate they receive then might differ from the one used when the benchmark is calculated days or weeks later.

But on a peer-to-peer platform, in theory liquidity on the platform will be there when asset managers need it at month-end, which could reduce tracking errors.

Circular logic

Moore launched the company in March 2019 along with Richard Leader and Emin Tatosian. The team is eight strong and based in New York.

For the platform's first run at the end of January, three members matched a couple of hundred million dollars in swaps trades. Six months later, the company says it is netting tens of billions in swaps each month. Moore won't say how many asset managers are currently signed up to the service.

The platform differs from the standard peer-to-peer trading model, with asset managers facing other asset managers and taking each other's credit. In fact, the business works much like a clearing house, with a bank operating as the central counterparty. In the case of FX HedgePool, the bank at the centre is Standard Chartered.

First, an asset manager uses the platform to find a matching trade. To execute the deal, the two firms book the transaction with Standard Chartered at the chosen benchmark rate, and as both trades offset, the bank is left with no market risk. Standard Chartered receives a fee for covering the credit component of the trade.

But the service can't gain scale with just Standard Chartered, as the bank and its clients would soon fill their own counterparty risk limits against each other. More liquidity providers are needed to create what Luke Brereton, co-head of prime services at Standard Chartered Bank, calls a middle ring of the structure. Brereton helped to design FX HedgePool's central credit model.

It works as follows. When two clients match their flows on the platform, they book the transaction with their regular dealers – assuming these dealers are members of FX HedgePool. The two dealers then offset the market risk of the transactions with Standard Chartered, leaving all the banks involved flat.

The dealers are effectively getting paid solely for taking counterparty credit risk against their existing clients, and Standard Chartered.

Standard Chartered acts as a quasi central counterparty for FX HedgePool

So far, five banks have signed up, including Standard Chartered. The others are Barclays, BNP Paribas, NAB and TD Securities.

Brian Perry, head of FX for Europe and Asia at TD Securities, says the provision of peer-to-peer liquidity is a growing piece of the market and something to add to the bank's wider product offering.

A key draw for the Canadian bank was its ability to leverage its own Aa1 and AA- counterparty credit rating from Moody's and S&P respectively, for its parent company, Toronto-Dominion Bank. Smaller banks like TD can sometimes struggle to win business against larger dealers purely on the basis of pricing. But with the pricing element removed, TD can compete on the more level playing field of credit quality.

"There is an opportunity here where clients can look at their panel of counterparty banks, they can direct their month-end flows based on credit rating," Perry says. "And as a bank with a strong credit rating, we see ourselves in a good position to benefit from that."

Know your limitations

There are barriers to the growth of the platform, however. Standard Chartered's Brereton points out that for peer-to-peer flow to work, you need equal trade volumes from buyers and sellers per currency pair. This has traditionally been the problem with efforts in the spot space – predicting daily trading requirements makes matching difficult. Forwards and swaps rolls are more regular and predictable, and directionality can be less tied to market movements, but lack of offsetting could still be an issue.

The platform is reluctant to put a figure on its success rate in matching trades. A European bank's head of FX says he read HedgePool's three-monthly data release recently, and noted that it did $34 billion in volume in March. But he says the firm did not disclose how much flow did not get matched off.

“When clients need to access markets quickly and transfer risk, they tend to go to their partner banks. How would [peer-to-peer] work in a situation like we just had? I think it would be problematic,” the head says.

Moore counters that publishing unmatched amounts would be misleading. He says a fundamental of HedgePool is to allow members to match positions within an anonymous and non-toxic environment where information is protected.

“Even if we did, members don’t necessarily show their full hand, so those figures would be artificial and meaningless anyway,” Moore says.

Market participants will understand that this new model – whatever it is – won’t replace the enormous value that the large banks bring to the marketplace. To some, these solutions will represent a viable supplement

Gil Mandelzis, Capitolis

Growth of the platform may also be restricted by the availability of credit among participating banks. While HedgePool doesn’t necessarily need a huge pool of large dealers to get going, eventually the asset managers will fill up their credit limits with Standard Chartered and the handful of other banks involved, and vice versa. That means the service will be structurally limited by how much other dealers are prepared to direct their credit appetite to clients through this platform.

“They may decide that this is not the way they want to use that credit line, that they want to fill it through trading directly with the client because of the information flow or the client relationship. So they may limit the amount of credit that they are prepared to deploy into the platform," says Standard Chartered's Brereton.

But Gil Mandelzis, chief executive at Capitolis, a fintech firm that has used a peer-to-peer model to establish a credit and risk capacity management service in the FX space, says banks' views on this area are changing.

Since the 2008 financial crisis, limits on balance sheet usage have been a bottleneck in the market. As a result, he says banks are becoming more open to new ways of working.

"Market participants will understand that this new model – whatever it is – won't replace the enormous value that the large banks bring to the marketplace. To some, these solutions will represent a viable supplement," he says.

The head of FX trading at the European bank says firms using peer-to-peer might be missing out on savings that can come from trading more opportunistically. For month-end swaps rolls, asset managers may sometimes be able to trade at cheaper prices with dealers earlier in the month. Committing their monthly trade flow to a single platform would deprive asset managers of this opportunity.

But other bankers acknowledge that, from a business perspective, it makes sense for asset managers to use peer-to-peer venues.

"I think it's something that the forwards and the swaps market will definitely look to evolve into, although at a much slower pace," says Tim Jones, head of international FX forwards, at Credit Suisse. "It needs to get the correct infrastructure in place, the correct supply base in place and who wants to do it at what time of month and so on."

Editing by Alex Krohn

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