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The 20 for 20 Countdown – Part Four

Galen Stops | September 23, 2019 | 6:00 AM

It's been a busy 20 years since Profit & Loss launched. Colin Lambert and Galen Stops have picked out 20 key events or trends during that time and asked senior industry figures for their perspective on them – here's numbers 5-1.

5. Chatrooms

It seems incredible that it is now over six years since word first broke of dealers allegedly colluding on Bloomberg chat rooms to fix spreads, organise trading into the London 4pm WM Fix and share information – six years that have caused the FX industry no end of heartache and soul-searching.

Fines have been paid by banks, staff have been dismissed and some re-employed after tribunal hearings, compensation has been paid and traders have even faced – and won – a court hearing in the US, but still the issue rumbles on thanks to the ongoing legal actions brought by customers the world over. How did the market get itself into such a mess, though? How can it be that in 2007, when the authorities alleged the activity started, banks were ignoring a missive put out by 16 of their own (under the auspices of the New York Foreign Exchange Committee) in 2001 which explicitly stated "Manipulative practices by banks with each other or with clients constitutes unacceptable trading behaviour"?

"The simple answer is hubris," suggests the former head of FX trading at a bank in London. "As the banking industry consolidated so the big got bigger and they just forgot some of the basics – thanks in no small part to these bigger banks chasing customer business no matter what the cost. As they won more business the trading desks came under more pressure and then the world discovered tracking error and the benchmark fix, which only piled on more pressure. The banks let their staff down over this whole issue, and I include myself in this. We should have realised that we were putting these traders in harm's way and done something about it, but nobody would – or could – face down the clients."

The very fact that information sharing was discussed at FX Joint Standing Committee meetings indicates there were concerns, and the former head of trading says this merely means there was a collective failure of responsibility. "That showed me we were all facing similar issues, and nobody was trying to do anything about it. A concern would be raised at a meeting and everyone would nod and agree it was serious and then put it off for a later date – looking at it now, the only thing that was going to stop it was action by the authorities."

Although for the individuals involved in the aftermath of the chat room scandal it is probably hard to see this, it can be argued that this was the catalyst for the FX industry reforming itself, most visibly through the FX Global Code. It also gave pause for thought elsewhere.

"I think that the FX scandals around the WMR Fix was a wake-up call for the real money community in particular," says the hedge fund manager. "I think many of them have changed the way they execute, whether it's getting away from the Fix, or using a different method to execute around the Fix."

The senior platform source in the US also believes the issue accelerated reform. "The scandals exposed some areas of the market that needed to be better understood and have led to an evolution of practices of business models in standards, procedures and policies as well as a broader understanding of how the market operates," the source says. "It's going to lead to further attempts at standardisation in the way that standards are applied across the marketplace."

Perhaps the last word on this should go to a trader caught up in the issue, who told Profit & Loss two years ago, "We knew what we were doing in sharing information – we were following orders. You were given targets in your job reviews and getting out there more on chat rooms was always high up the list."

Speaking more recently, the trader adds, "This is what saved the Cartel guys – the jury saw not only this but the fact that everyone was doing it and at the time it wasn't seen as wrong. To me the significant indicator that this was how it was can been seen in how instances of information sharing stopped the minute the banks put a halt to it. One day you were told to get information, the next you weren't so you stopped. This was not an individual failing, this was cultural."

4. The FX Global Code

The FX Global Code was the direct result of the fallout from the chat room scandal – it's the FX industry's defence mechanism against probably over-prescriptive regulation. There remain issues, not least what one member of the Global FX Committee's buy side outreach group recently termed the "extremely poor" response by customers generally to sign up, but generally speaking, with a tweak here and there, the Code is seen as having a positive influence on FX markets and, just as importantly, how they are perceived.

Maxine Dennis

"The Code allows us, as an industry, to go to the buy side and say, 'here is what we do, and how we do it', it has established behavioural standards that everyone knows and can adhere to," says Maxine Dennis, an FX trader with 35 years' experience who recently left SocGen/Newedge in London.

"The Global Code epitomises FX and how it deals with challenges within its own business," says Kate Lowe, global head of trade services at State Street. "It represents our self regulating culture – it's well written, easy to understand, and practical."

For some, the has effectively formalised existing processes.

"I think there was always an unspoken code in the FX market," says one FX industry veteran. "There were always these unwritten rules of the game and if you broke those rules then nobody would quote you, or they wouldn't quote you well – and I think that structure saved our asset class from the global financial crisis. Just by putting it in writing and getting people to sign up to it, the Code gave us something that we could take out to the broader world, put it in front of them and say, 'Hey these are the principles that our community has embraced for a long time, but if you weren't in our community you might not have known them'."

It is in some ways a paradox that a set of principles, rather than regulation is seen as providing clarity over people's actions, but the Code is first and foremost about making people think about what they are doing and if what they are doing is acceptable.

"Personally, I think over the last decade the most important development in the market has been Principle Eight, which says that people need to be clear on the capacity in which they're acting – as a principal or an agent," says James Sinclair, chairman of MarketFactory. "Because that is at the root of a lot of the issues that the industry has had not just recently, but going back some time – in what capacity am I acting, what are my motivations?"

It is testament to the Code's impact that it is cited so broadly in the FX business, it is not just something for the voice segment of the market to get their heads around. Chris Purves is head of UBS's FRC Strategic Development Lab, which is tasked with developing products and services for the bank to use years, rather than months ahead, but he is keen to cite the importance of the Code.

"There is more trust in the FX market now thanks to the FX Global Code, there is a lot more confidence that the banks are doing the right thing and that's been good because it means people will be more open to innovative ideas," he says.

There is little doubt that there is work left to do on the Code – as Tod Van Name, head of FX electronic trading at Bloomberg, observes, "There are still a lot of points of the Code that are under debate and that includes last look and pre-hedging. I think the market is getting closer and closer to some sort of consensus, although the debate is still pretty intense.

James Sinclair, MarketFactory

"Now, however, you have the FCA saying that they actually support and endorse the use of the Global Code, which changes everything dramatically because now you have regional regulators saying: 'we expect people to understand what the Code is and does and to be able to communicate what their internal policies are to support the notions or the principles of the Code that pertain to them'," he adds. "Now it's not just a set of guidelines, it's much more tangible."

There are, however, as Sinclair points out, less tangible benefits.

"The framework of the Global Code, had it been around, might of helped me explain my job to my mother who was a highly principled Quaker," he says. "I could never quite convince her that my job was not just promoting gambling. You know how it is with mothers, and my mother was particularly so – if you couldn't explain your point succinctly you'd get "yes dear" and then you'd know the conversation was over. That I could not explain the social benefit convincingly in my youth is a regret."

Perhaps sentiment towards the FX Global Code is best summed up by someone who worked on its creation, George Athanasopoulos, global head of FX, rates and credit at UBS, who says, “I am very proud to have been a part of the group that worked on the FX Code, that is a significant event in the market because we now have a gold standard for conduct and that is hugely important.”

3. EBS Prime

This may seem a strange event to place so high in our countdown of significant events, but following the launch of the multi-dealer portals in 2001-02 there remained a frustration amongst certain client sets over their lack of access to the core FX market.

As Athanasopoulos observes, “Banks used to be the clients’ window on the markets. They provided credit, pricing and information, but that has now changed – technology has meant we can unbundle these services. Prime brokerage and clearing have also played a huge role here and it has forced banks to rethink their models, there is no longer that strong bond between bank and client that there used to be, clients can now take small pieces of the service.”

It can be argued that the road towards this situation started with the launch of EBS Prime, initially in 2003 to regional banks and then, more importantly for many, to the professional trading community in 2005. With the opening and then extension of the service, the FX industry’s primary market in the G3 currency pairs was now open to anyone with a prime brokerage account.

“EBS Prime was a game-changer,” observes the head of FX at a bank in London. “All of a sudden you were getting clients querying their pricing because it was tighter on EBS and saying that they were getting that pricing from other LPs – it forced everyone to tighten spreads and compress margins.

"There was a problem created that I still don't think has been solved, however, and that is the depth of book on EBS," the head continues. "There is a lot more fleeting liquidity there and on the other platforms; top of book has definitely got tighter but thinner; and this is largely thanks to the HFTs being allowed on through EBS Prime. You could argue that this has forced the banks to improve their technology and that customers get a better experience, but it can also be argued that market quality has degenerated and a big factor in that was the opening up of the primary market to everyone."

George Athanasopoulos, UBS

A source who was at EBS at the time tells *Profit & Loss* there was some disquiet over the launch, but not to the degree that the venture was under threat.

"We had a few bank trading desks ask us what we thought we were doing, but then we'd go across the floor to the PB teams and they loved it," the source recalls. "That may have been the first instance of tension between trading and PB, I don't know, but it certainly existed around EBS Prime."

The source also suggests there were internal concerns, so much so that the announcement was carefully timed. "I was told that EBS Prime was announced more or less at the same time as a link up with Bloomberg because management was concerned about a negative reaction and if they had that, they could focus on the Bloomberg deal. I am not sure if that was the case but if it was, I don't know why they were worried – EBS was owned by the banks at that time and the board ratified the move – probably the banks were already looking ahead to a sale and this could bump up the price."

There is a case for the swathe of launches in the multi-dealer portals space to have a place in this list, however they really only automated an existing process by allowing clients to put banks in competition in one place, rather than via four or more phone calls.

With EBS Prime, FX finally became a democracy, with the right access anyone could have the same exposure to the market as the biggest bank. Of course it can also be argued that the technology arms race has meant that democracy has been diluted, but one look at a primary market ECN tells you that FX is an open asset class for all different types of players – and that started with the idea for EBS Prime.

2. Lehman and the GFC

"The Global Financial Crisis (GFC) changed the nature of markets, it prompted a regulatory overhaul, altered how institutions interacted in the market and ran their own businesses, and started the trip to where we are now – a world with structurally very low interest rates," says UBS's Athanasopoulos. "I don't think there is a market participant that hasn't been affected by that event."

Bloomberg's Van Name agrees, "I don't think anyone in the market right now could say that the financial crisis didn't have an impact on the way that we trade today."

One thing that is clear, however, is that the events of 2007-08 were not a currency crisis. As Adrian Lee's founder observes, "The fascinating thing about currencies is that they're always sort of the second order effect. It was a financial crisis, not a currency crisis, but it did lead to a tremendous amount of regulation over the next 10 years that followed, some of which we're still dealing with now. And although it wasn't a currency crisis, there has been a huge effect on liquidity for the brokers – banks are not quite in the same business they used to be."

Joe Hoffman, CEO of the currency management group at Mesirow Financial, believes the GFC is probably one event that really altered a lot of the market behaviour. "I think it taught people that credit risk is real, and it must be managed, that banks can fail and there are consequences for not managing that risk. The regulations that followed the financial crisis are still impacting us today, a decade later."

So the regulatory influence on markets is undoubted, but there were also economic factors at play – as noted by Athanasopoulos.

Van Luu, head of currency and interest rate strategy for Russell Investments, says: "I can think of two major consequences of the global financial crisis on forex markets. One is that, while I was studying economics and finance, covered interest parity was basically one of the laws of nature of the markets,

Tod Van Name, Bloomberg

and now we've seen quite persistent deviations from covered interest parity and forward discount or premium not reflecting interest rate differentials as you traditionally measured them.

"The other thing is that interest rate differentials have become very, very compressed," he continues. "When you look at the difference between the high carry basket and the low carry basket before the crisis, it was on average about 4% between the high yielders and the low yielders. After the crisis it's basically half that, so it's much, much more difficult to make money from the carry trade in developed markets."

The impact of the GFC cannot be understated when it comes to financial markets, but it could also be that the risks have merely been shifted from one area of the industry to another – as one senior figure asks, does the world really know the impact on the industry of a CCP failure?

That said, for the FX markets, while there has been no avoiding the pervasive influence of regulation, the GFC remains something that largely happened in other markets and that it actually worked pretty well throughout.

"We had Bear Stearns, Lehman Brothers and Merrill Lynch fail and the market kept on working and the way that it was supposed to," says the senior platform manager in the US. "It's a testament to the FX market, a market that is largely unregulated, that it worked exactly in the way that it was supposed to. It continued to meet all of its obligations and maintain business continuity. CLS and, frankly, electronic trading enabled the market to kind of overcome the monumental shock waves that happened after that."

1. "SNB Day"

"As an exercise in how not to do something, January 15, 2015 stands out as the number one lesson," says the head of FX at a bank in London. "If you wanted to destroy a market with one action, the Swiss National Bank are the people to call – on that day they caused so many issues that frankly I am not sure if the FX market will ever fully recover."

The FX head points out that liquidity levels in 2014-15 were recovering nicely from the GFC-inspired drop and that market participants were getting more comfortable with risk. That all changed when the Swiss central bank pulled its 1.2000 bid from the market, prompting what one market participant called "a bloodbath". At one stage on EBS, the market traded at 0.00125 according to sources at the time, without doubt millions of euros changed hands a long way below what eventually established as the "official" low of 0.8500.

"Coming on top of the chat room scandal which had seen a bunch of experienced traders exit the market, the FX industry just wasn't ready for something like this," says the head of FX. "We had kids sitting on the desk that we were training up, because after all – EUR/CHF rarely moved that far!"

There is little doubt that the Swiss National Bank-inspired flash crash highlighted the inadequacies at that time of some electronic risk systems,

prices were being hit 40, 50 and even 60 big figures below the eventual low, but it also served to reinforce why the human still has a role on the desk, as one senior e-FX source explains, “We messed up,” he says. “We learnt a lot that day about
pricing and data feeds.”

Van Luu, Russell Investments

The source continues, “It highlighted to me why we have experienced human traders sitting on the desk – the algos couldn’t work out that the SNB had made a mistake and that they didn’t want it down at 80 cents, they just reacted to the data they were seeing. It was human traders who stopped the rot, they understood what was going on and what the SNB’s intentions really were and the word was given, ‘don’t sell below 1.05’. This was our line to the customers as well, which helped them – it helped inject some sanity into a desperately chaotic situation.”

Dennis feels the same. “That was when experience really counted, you could say ‘turn off the hedging engine and give it to us’, the market went back to being manual and that is how it recovered.”

A source familiar with the matter has told Profit & Loss that the SNB did in fact try to enter bids on EBS but couldn’t because they were too far from the last trade, as the head of FX in London observes, "If nothing else, a central bank now knows to put liquidity into the ladder at appropriate points before they pull the plug."

January 15, 2015 changed so much in the market. It refocused attention on the need for experienced oversight of the e-FX trading technology; it highlighted the weakness of the recycled liquidity model that boasted "Tier 1 pricing" only to see that disappear in a flash; it put a tremendous strain on prime brokerage businesses; and it wiped out brokerage firms, hedge funds and individual traders alike.

Again though, and this is testament to the nimbleness and awareness of the FX industry – it prompted a response. "There was a tremendous technology awareness that came as a result of that day as to how many trades can you fit down a garden hose?" says

Steve Flanagan, veteran FX trader and currently head of FX ecommerce risk at JP Morgan in New York. "Certainly bandwidth and automated risk management tools became a major topic of conversation and moved to the top of every bank's project list."

There were people in the FX industry who looked at the equities market flash crash in 2010 and said, "it couldn't happen in FX". The foreign exchange market is so often touted as the deepest, most liquid market in the world, as indeed it is. It is, however, far from perfect and January 15, 2015 can probably be designated the day that the FX industry lost its innocence.

Galen Stops

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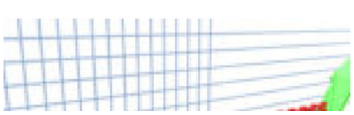

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