GFXC Discussion on the Operational Challenges to the FX Market During the 2020 Coronavirus Crisis

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Introduction

The Coronavirus lockdown of 2020 presented a major challenge to FX market participants. A wave of country-by-country lockdowns swept across the FX industry globally from January through April. With little notice, market participants needed to leave dedicated trading floors and establish operations in alternative locations. For many market participants, especially on the buy-side, this meant migrating trading operations to employees' homes. Organizations had to adapt their internal trading practices, and the way they communicated and executed transactions with their counterparties, at very short notice. On top of these challenges, the six-week period from the late February to the end of March saw increased market activity and volatility. Market participants needed to handle these challenges within their new 'lockdown' trading environments.

Starting early in 2020 and continuing through the early phases of the lockdown, local FXCs met regularly to provide news updates, discuss market conditions and share emerging best practices. FXC members found these meetings useful in helping to navigate through this unprecedented period.

Part of the Global Foreign Exchange Committee (GFXC) meeting in June 2020 included a group discussion sharing the experiences and learnings of the previous six months, as well as considerations for the future. This document further illustrates some of the key points of the discussion.

Takeaways: High-level Code principles with broad application during the Coronavirus lockdown

Governance:

Principle 4: The body, or individual(s), that is ultimately responsible for the Market Participant's FX business strategy and financial soundness should put in place adequate and effective structures and mechanisms to provide for appropriate oversight, supervision, and controls with regard to the Market Participant's FX Market activity.

Principle 7: Market Participants should have appropriate policies and procedures to handle and respond to potentially improper practices and behaviours effectively.

Risk and Compliance:

Principle 27: Market participants should have practices in place to limit, monitor, and control the risks related to their FX Market trading activity.

Principle 33: Market Participants should have business continuity plans (BCPs) in place that are appropriate to the nature, scale, and complexity of their FX business and that can be implemented quickly and effectively in the event of large-scale disasters, loss of access to significant trading platforms, settlement, or other critical services, or other market disruptions.

Principle 36: Market participants should keep a timely, consistent, and accurate record of their market activity to facilitate appropriate levels of transparency and auditability and have processes in place designed to prevent unauthorised transactions.

Principle 38: Market Participants should have in place reasonable policies and procedures (or governance and controls) such that trading access, either direct or indirect, is limited to authorised personnel only.

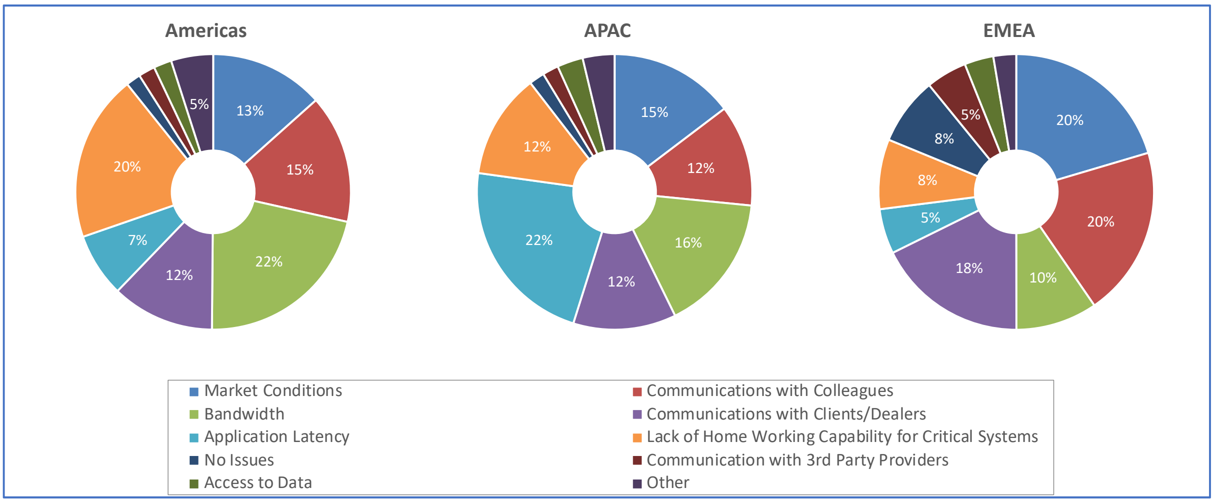
Overview of Challenges Faced by Market Participants

Overall, the transition in the lockdown environment was smooth. No major operational issues arose, even during the period of high market volatility in February and March.

Takeaways: High-level Code principles relating to Operational Resilience *Risk and Compliance:* *Principle 24: Market Participants should have frameworks for risk management and compliance.* *Principle 26: Market Participants should maintain an appropriate risk management framework with systems and internal controls to identify and manage the FX risks they face.* *Principle 32: Market Participants should have appropriate processes in place to identify and manage operational risks that may arise from human error, inadequate or failed systems or processes, or external events.*

To help quantify the feedback provided by market participants, this paper references a survey conducted by Refinitiv in May/June 2020[1]. The survey responses represent a significant percentage of buy- and sell-side participants in the global FX market. They have provided a wide diversity of views and ample information that show trends and divergences of opinion. In addition to using the Refinitiv survey, this paper also uses data provided by Refinitiv to illustrate trading conditions in the FX market.

What have been your biggest challenges working from home?



Source: Refinitiv 2020 client survey

The survey response shows that there were multiple challenges, with no single issue especially dominant. There was some variation between regions, but overall the global picture was consistent.

[1] Refinitiv is a market data provider and operator of two FX trading platforms: FXall and Refinitiv Matching. Refinitiv surveyed 1,000 customers about their experiences during Q1 and Q2. Respondents covered more than 50 countries (EMEA 48%, Americas 28% and APAC 24%) and the four major industry segments (banks 45%, corporations 39%, asset managers 12%, hedge funds 4%).

Market conditions were not a dominating challenge in any region. In fact, in the Americas and Asia-Pacific (APAC), they were not even identified as the biggest single issue.

Aside from market conditions, the most commonly raised issues concerned communication, either with colleagues or with clients/dealers. Lockdown conditions have highlighted the extent to which the FX industry is a people business. Market participants miss the easy ability to connect with each other when working in a lockdown environment.

Looking regionally, Americas highlighted the challenges of using critical internal systems that are not well adapted for use via Virtual Private Network (VPN) connections or the Internet. Asia highlighted the challenges of additional latency in the work from home environment. For Europe, the Middle East and Africa (EMEA), market conditions and communications, with both colleagues and counterparties, were the biggest issues.

Discussion during the June GFXC meeting highlighted further challenges related to communication:

- Electronic trading proved efficient and effective during the lockdown period, and much easier to operate when traders and salespeople were locked down in different physical buildings. Many smaller banks had accelerated their electronification agendas.

- For many banks, it had been a challenge to make markets in fast moving products such as FX Spot in the lockdown environment. The speed of these markets benefits from a traditional trading floor setup. From the earliest days of lockdown, banks reserved their limited capacity on trading floors (after following social distancing guidelines) for market making in these products.

- Effective risk taking by banks was more difficult in a lockdown environment. It was difficult for an isolated trader to accept a large risk position, and difficult for the bank to manage risk positions in the lockdown environment. This was one of the drivers for the reduced availability of liquidity for large sizes during the lockdown period, and the increased amount of interbank hedging of positions received from clients.

Takeaways: High level Code principles relating to Communication

Information Sharing:

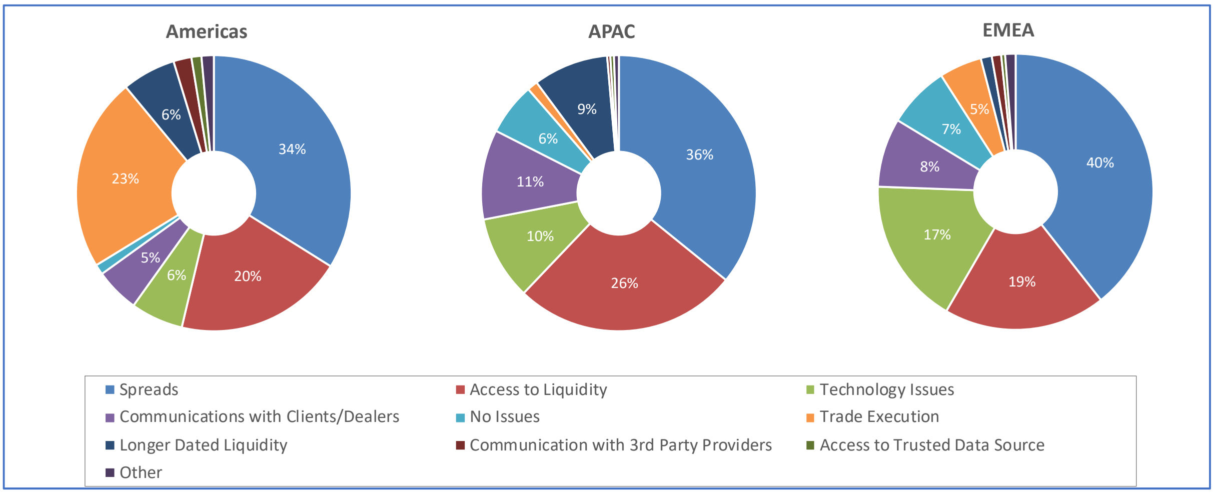
Principle 19: Market Participants should clearly and effectively identify and appropriately limit access to Confidential Information.

Principle 23: Market Participants should provide personnel with clear guidance on approved modes and channels of communication.

Principle 20: Market Participants should not disclose Confidential Information to external parties, except under specific circumstances.

Trading Challenges Faced by Market Participants

What has been your biggest trading challenge of Q1 2020?



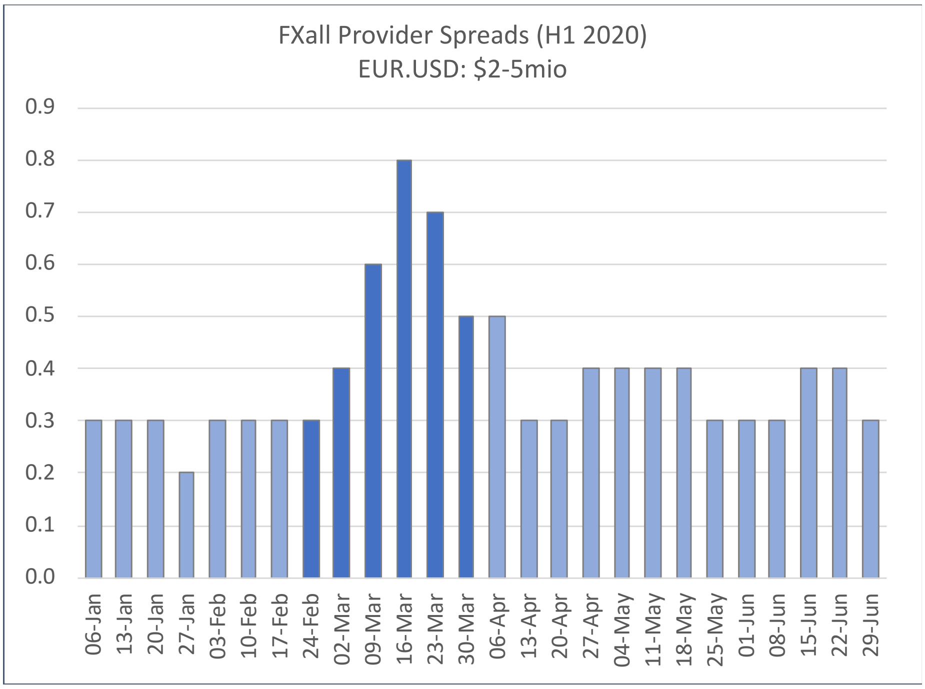
Source: Refinitiv 2020 client survey

The survey response showed considerable agreement here between market participants in different regions. The #1 issue cited was the increase in spreads. The #2 issue cited was difficulty accessing liquidity, which means the ability to deal in the size required at a reasonable spread.

While liquidity difficulties are primarily related to 'market conditions' for many FX market participants they also entailed operational challenges. Especially on the buy-side, where FX hedging is seen by FX market participants as an operational task arising from their core line of business. If this task becomes either difficult (e.g. liquidity not available) or materially more expensive (e.g. spreads widening), then they perceive that they have an operational problem with their hedging processes. And during the peak of the crisis, many market participants did have to adapt their normal FX hedging procedures given the adverse market conditions.

Spreads in the dealer-to-customer market peaked at 2-3x previous normal levels depending on the currency pair, while spreads in the interbank market peaked at 3-5x previous normal levels. For many buy-side customers, it became cost prohibitive to hedge at these increased spreads.

Taking provider spreads seen on FXall as typical of industry levels, the chart below shows the evolution of spreads through the lockdown period for EUR.USD. The pattern is generally similar for other currencies.



Source: Refinitiv

The discussion in the June GFXC meeting corroborated these challenges and added some more detail:

- For participants in Emerging Markets, both on the sell-side and the buy-side, another challenge had been a reduction in the amount of liquidity available relative to G10 liquidity.

- From an operational perspective, the buy-side's transition to a lockdown environment had been relatively straightforward. The buy-side's key challenge during lockdown had been uncertainty about hedging strategy. Faced with the twin problems of commercial uncertainty in terms of future cash flows to be hedged, and an increased price for executing any hedges in the market, the most obvious action for many buy-side participants had been to cut back on their hedging activity until there is greater certainty.

- Some buy-side participants made increased use of algos during the crisis period in an attempt to reduce execution costs and ensure best execution in the difficult market conditions.

Takeaways: High-level Code principles relating to challenging Market Conditions

Execution:

Principle 9: Market participants should be aware of the risks associated with the transactions they request and undertake.

Principle 9: Market participants should clearly understand how orders will be handled and transacted

Principle 12: Market Participants should not request transactions, create orders, or provide prices with the intent of disrupting market functioning or hindering the price discovery process.

Principle 10: Market participants should handle orders fairly, with transparency, and in a manner consistent with the specific considerations relevant to different order types.

Principle 10: Market participants should price transactions in a manner that is transparent and consistent with the risk borne in accepting such transactions.

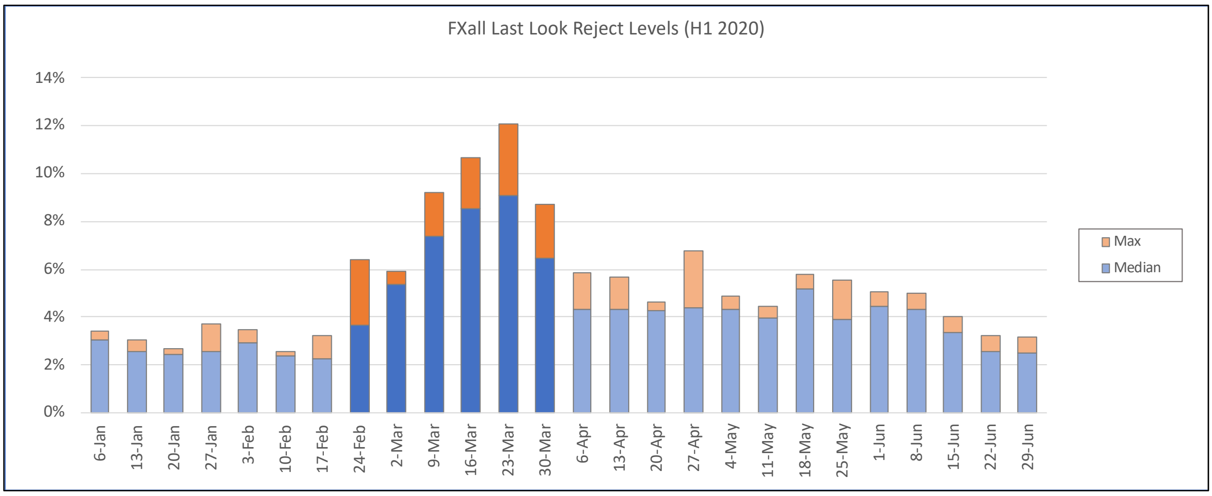
Principle 10: Market participants should exercise particular care and attention when handling orders that have the potential to have sizable market impact.

Principle 10: Market participants should ensure adherence to internal guidelines and procedures for collecting and handling executing orders.

Principle 14: The Mark Up applied to Client transactions by Market Participants acting as Principal should be fair and reasonable.

E-Commerce Technology Challenges Faced by Market Participants

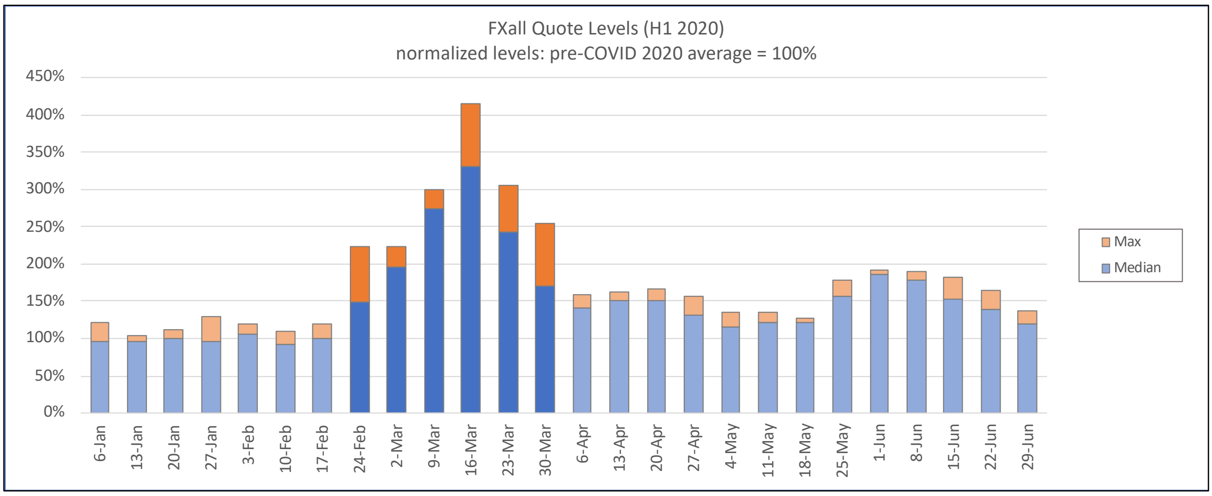
In their survey answers, market participants also pointed to general challenges with trade execution. This is backed by data showing that last look reject rates[2] increased significantly during the peak of the crisis in late March. Again, using FXall data as indicative of the overall market, reject rates for buy-side institutional customers increased from a typical 2-3% level before the crisis to a peak of over 12%. They dropped rapidly after the end of March, and then steadily returned to normal over the course of Q2.



Source: Refinitiv

An additional challenge was the increased quoting frequency experienced by market participants during the crisis period. Again, using data published by FXall as indicative of the general market, bank rate engines were quoting at up to 4x normal speeds during the peak of the crisis:

[2] Last look is a practice utilised in Electronic Trading whereby a Market Participant receiving a trade request has a final opportunity to accept or reject the request against its quoted price. The FX Global Code recommends that Market Participants employing last look should be transparent regarding its use and provide appropriate disclosures to Clients. Detailed guidance on the use of Last Look is provided in Principle 17 of the Code.



Source: Refinitiv

This increased rate of quote publication created additional workloads on user's trading applications as well as generating more data that needed to be collected and stored by market participants. These factors created second order effects that increased the challenges faced by market participants.

Takeaways: High-level Code principles relating to electronic trading

Execution:

Principle 17: Market Participants employing last look should be transparent regarding its use and provide appropriate disclosures to Clients.

Principle 18: Market Participants providing algorithmic trading or aggregation services to Clients should provide adequate disclosure regarding how they operate.

Role Played by the FX Global Code during the Coronavirus Crisis

A notable feature of the lockdown period was the extent to which stories about trading and conduct did *not* appear in the industry press. This may reflect the extent to which good conduct, increased transparency between counterparties, and greater market knowledge has become embedded as part of ordinary industry practice. These changes have been driven by a number of factors since the 2008 Global Financial Crisis, one of which is the FX Global Code.[3]

The Code has helped drive the adoption of robust operational and risk management practices by Market Participants. This was one of the key reasons why the industry was able to move through the challenges of February and March without a major operational incident.

During the early stages of the Coronavirus crisis:

- Adopting the principles in the Code helped market participants to navigate recent market conditions with increased confidence, and a greater sense of empowerment to ask counterparties about trading challenges such as increased spreads, reduced sized, and increased last look reject rates. Combined with increased usage of data and analytics by industry participants, the result has been a wider acceptance of the changes in liquidity market conditions than we have seen in some previous crises.

[3] The FX Global Code is available on the GFXC website at https://www.globalfxc.org/fx_global_code.htm.

- Members of local FX Committees and the GFXC remained in regular communication and were able to provide an overall point of focus for the global FX community's response to the crisis. A good example was the Tokyo FX Committee's memo "Notes on Work from Home" reminding market participants of their conduct obligations arising from the Code. A second example was the GFXC statement of 26th March[4] highlighting market conditions ahead of quarter-end and urging market participants to review their quarter-end execution needs ahead of time.

- Thirdly, the GFXC has been able to remind market participants of the industry's shared goal, to maintain and protect the integrity of the FX market. Also from the 26th March communication: "In these unprecedented times, we encourage market participants to be aware of how their actions can ensure the FX market remains robust, open, fair and appropriately transparent such that market participants are able to confidently and effectively transact at prices that reflect available market information and in a manner that conforms to acceptable standards of behaviour."

Future Considerations

As of June 2020, most participants in the GFXC discussion reported that their institutions were preparing for an extended period of lockdown, likely continuing until 2021. Most participants felt that the day-to-day running of their trading operations had adapted for lockdown and could continue for the foreseeable future.

However, market participants also shared some considerations their institutions had been reviewing about the longer-term challenges of lockdown. These represented hot topics on management's radar as they prepared for the remainder of 2020 and 2021.

- Strategic planning and transformation. Most participants felt this was more difficult while in a lockdown environment and were reviewing how to approach 2021 planning.

- Control and compliance was widely regarded as an increased challenge in a lockdown environment. Many market participants have controls in place to limit access to mobile phones, Internet email, and the World Wide Web from their trading floors. These controls would need to be rethought and reimplemented for lockdown.

- Finally, the rapid transition to lockdown had the potential to frustrate recent progress by the industry on increasing diversity within the workplace. As schooling and homecare is disrupted, it is possible that the burden will fall more heavily on women and reduce their ability in participate in the workplace. On the other hand, the experience of lockdown has shown that flexible workplace arrangements can work well in practice. Continuing with these arrangements past the end of lockdown may make the FX industry more attractive to those for whom traditional office-based working practices are too restrictive. Many market participants are now thinking about how to adapt their work-from-policies in the longer term in order to maintain the best advantages of lockdown going forward.

- Ensuring that new staff, especially new junior staff, are effectively trained. This includes ensuring that new junior staff know what constitutes good practice in the FX market, in other words that they understand and adhere to the FX Global Code.

[4] GFXC "Statement on FX Market Conditions", 26th March 2020.