New City Initiative

The Changing Face of Foreign Exchange

Hidden Cost or Undiscovered Treasure?

www.newcityinitiative.org

About the New City Initiative

NCI is a think tank that offers an independent, expert voice in the debate over the future of financial regulation.

Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, an old fashioned "client-centric" approach has enabled entrepreneurial firms in the Square Mile and beyond to emerge as a growing force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

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Henry has over 30 years experience in the global financial markets in trading, sales and front office management roles. He is an experienced capital markets professional with an excellent understanding across the Foreign Exchange, Money Markets, Fixed Income, Equity and Derivatives markets. Henry operates as a consultant using his extensive experience to offer independent and specialist advice to institutional investors, asset managers and wealth managers on all aspects of the foreign exchange markets and products. He is currently in the process of establishing a new business venture, called Institutional FX Advisory Partners, to deliver a broader range of services.

Prior to this, he worked for various international banks in London and New York primarily focused on the global asset, wealth management and private banking sector. Since 2000 his role was Global Head of FX sales and client relationships at Brown Brothers Harriman managing teams in Tokyo, Hong Kong, London and New York. Previously he was Head of Trading and Deputy Branch manager at Bank Julius Baer in London.

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Contents

Objectives 3
Executive Summary 3
Summary 4
Recommendations 4

FX Market Background 5
FX is an Essential Ingredient 7
The Size of the FX Problem 9
Establish Priorities for FX 11
Why The FX 4.00pm FIX? 13
What is Next in FX? 15
Recommendations for Regulators 17
Summary of Advice for Asset Managers 19

Conclusion 20

New City Initiative Members 21

Objectives

This paper looks at the current challenges that confront institutional investors from the changing face of Foreign Exchange and identifies some of the opportunities these changes present and how they can bring direct business benefits. FX is a necessary part of any asset management business that invests internationally and the costs associated with pricing FX transactions are often unclear or unknown. This paper attempts to quantify the extent and significance of this problem by reviewing the size and the mechanics of the global FX market and the European fund industry.

The paper then goes on to review the impact of recent and future regulation such as MiFID II, which is regarded as a positive influence, particularly in areas such as best market practice and transparency. The paper explores the positive benefits these could bring to institutional investors and asset managers and focuses on some of the immediate actions needed to improve the FX investment processes.

Following the recent press coverage of possible manipulation of the London 4.00pm FX FIX, this paper reviews the purpose and significance this has on FX trading. An analysis of the Fix seeks to identify the advantages and disadvantages of using it as a primary method of pricing FX transactions.

The paper then takes a look at what is coming next for FX and how institutional investors and asset managers can use new technology and products to drive operational efficiencies and monitor transaction costs. Finally, the paper offers some recommendations for regulators and advice for asset managers to help deliver direct business and financial benefits.

Executive Summary

The last few years have been turbulent times for all those involved in the financial markets as they come to terms with all the changes in regulation, market behaviour and market practice. In the past, buy-side institutions such as institutional investors, pension funds, asset managers, wealth managers and private banks have tended to be immune from any turmoil. This time is completely different as the changes are more far-reaching and the upheaval is having a significant impact on all financial market participants, but it has come as a particularly major shock to the fund management industry.

Clearly there has been an increase in costs as a result of compliance with the new risk and regulatory regime. Frequently, additional resources are required to meet the extra administrative burdens associated with doing business in the current environment. Undoubtedly these do not fall fairly across the spectrum of institutions involved and become a barrier to entry for new specialist entrants.

One way institutional investors and asset managers can turn this new business environment to their advantage is in the area of FX. These new regulatory changes are a unique opportunity to upgrade their business model, their FX operational processes and improve efficiency to reduce investment costs and improve fund performance.

Summary

- **Mispriced FX transactions cost the European fund industry and their underlying clients EUR1.5 billion per year, on a conservative basis.**

- **A conservative estimate shows that $590 billion of FX transactions related to institutional investments is at risk of being mispriced on a daily basis.**

- Recent events demonstrate there is a potential to misprice client FX transactions. It is clearly the responsibility of institutional investors and asset managers to ensure they receive the best FX pricing and best execution from their banks, at all times.

- The London 4.00pm FIX carries too much influence and is a flawed method of execution. The interests of banks and clients are conflicted.

- Market activity around the FIX is irrational and generates a spike in volatility resulting in an increase in market spreads. Trading FX at the London 4.00pm FIX is predominantly one directional skewing market pricing and adding a false premium to market pricing.

Recommendations

- Investors and asset managers must review internal trading strategies and practices to comply with regulatory requirements, business objectives and best market practice.

- Investors and asset managers should use MiFID II to improve transparency and clarity in their FX process, specifically the trading strategy and market practice with banks. Create a competitive advantage by demonstrating to clients their best interests are being protected.

- There is an urgent need for institutional investors and asset managers to use independent FX transaction cost analysis (TCA) in their investment process. Use TCA data to make informed decisions to improve trading strategies and practices and reduce trading costs and efficiencies.

- Investors and asset managers should access and utilise consultants with FX market expertise, experience and knowledge to maximise the benefit of new technology and trading venues.

- Regulators should communicate clearly and in a cohesive manner any new regulations and directives to the market using local associations and trade bodies as points of contact for follow up seminars and workshops.

- Regulators should not operate a “One size fits all” methodology to impose new regulation. Differentiate requirements as to size and type of activity and use a gradual implementation process. Start with systemic risk institutions and move through the spectrum.

- Regulators should clearly state and stick to their timelines helping to avoid confusion.

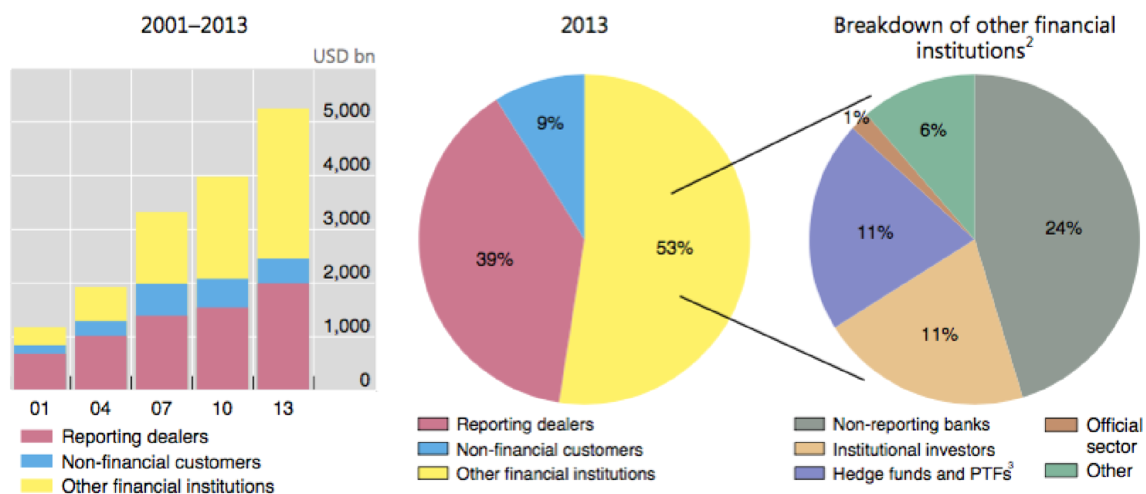
FX Market Background

Since the global meltdown in 2008, many forces have been operating in the financial industry, all of which have influenced and shaped the behaviour of the markets and its participants. None more so than the foreign exchange (FX) market which has been rocked to its very foundations not only by increased regulatory oversight but more importantly by all of the scandals surrounding market abuse, rate fixing and trader collusion resulting in record fines levied by US and European regulators on the major global FX banks.

Banks were forced to raise more capital in order to maintain their balance sheet support of their proprietary trading operations and protect their credit ratings. This had an immediate impact, insofar as it reduced risk appetite and liquidity in many of the financial markets. Foreign Exchange was no exception even though the majority of the daily transactions are Spot (T+2 settlement). Banks were less willing to fulfil their role as market-makers to the plethora of market participants in as broad a range of currencies in the larger sized trades. This was particularly obvious in the Swap and Forward market, which are predominantly used by institutions for hedging purposes.

Chart 1: Foreign exchange market turnover by counterparty[1]

Net-net basis, daily averages in April



[1] Adjusted for local and cross-border inter-dealer double-counting, ie "net-net" basis. [2] For definitions of counterparties, see page 19.
[3] Proprietary trading firms.

Source: BIS Triennial Central Bank Survey.

The most recent Triennial Central Bank Survey of Foreign Exchange Turnover published by the Bank of International Settlements (BIS) in April 2013 illustrates this trend. Trading in foreign exchange markets averaged $5.3 trillion per day in April 2013, a significant pick up from $4 trillion in April 2010 and $3.3 trillion in April 2007. FX swaps were the most actively traded instruments in April 2013, at $2.2 trillion per day, followed by spot trading at $2 trillion. The FX market has grown dramatically since the global credit crisis primarily driven by financial institutions other than reporting dealers. The 2013 survey collected a finer sectoral breakdown of these other institutions for the first time. Smaller banks (not participating in the survey as reporting dealers) accounted for 24% of turnover, institutional investors such as pension funds and insurance companies comprised 11% and hedge funds and other proprietary trading firms accounted for another 11%. Trading with non-financial customers, mainly corporations contracted between the 2010 and 2013 surveys, reducing their share of global turnover to only 9%.

This is a key shift in market dynamics because traditionally regulatory change and market behaviour only had a direct impact on the bank or sell-side of the market. Historically financial institutions or buy-side relied on their FX bank providers or custodian banks to advise and support them on meeting and implementing any required new regulatory procedures and best market practice. As a result of the various market scandals and the banks' pre-occupation with sorting out their own in-house issues, institutional investors' confidence in a small group of providers has waned somewhat. Institutional investors were therefore forced into a situation where they had to take responsibility for reviewing, assessing and implementing new and onerous regulatory changes.

Foreign exchange has become a contentious issue because most institutional investors only use FX as a secondary transaction in their overall investment process linked to the purchase or sale of an underlying portfolio asset. This paper looks at the challenges that institutional investors face and identifies ways these can be turned to their advantage by improving their FX processes to maximise the financial benefit to their businesses

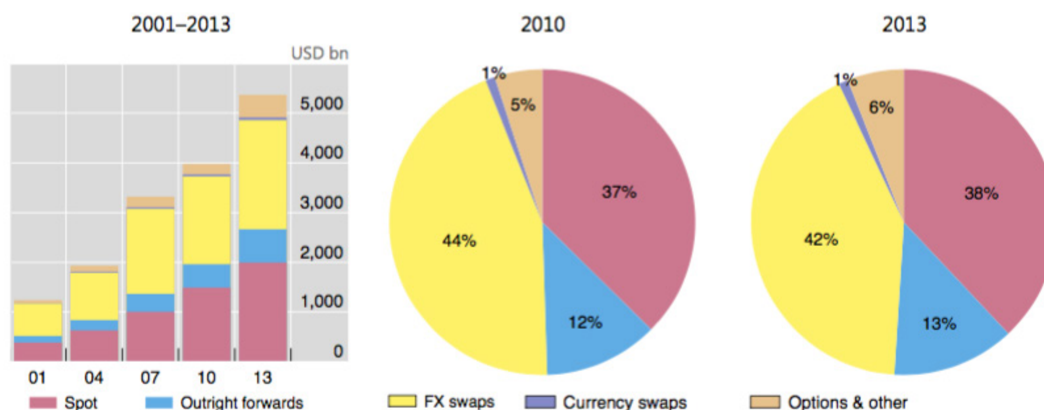
FX is an Essential Ingredient

Foreign exchange is an essential part of every institutional investor's business model and until recently has been lurking in the background unnoticed but it is now firmly on the radar for a number of reasons. One issue that has recently come to light is the cost institutional investors are paying for their FX transactions. When investing in global stock markets investors have to convert their currency into the currencies of the foreign countries in which they invest. The investor or the fund they manage stand to lose money if the FX prices applied to these transactions are not competitive with the market. This first hit the headlines in 2009 when public pension funds in the US accused custodian banks of allegedly cheating them by overcharging them significant amounts of money on foreign exchange trading.

The exact nature and extent of this problem is unclear but further analysis of the size and nature of the FX market demonstrates that the extent of the problem is significant. The fact that the FX market is more complex and idiosyncratic than individual stock markets makes it even more difficult to quantify the actual cost of each individual transaction. FX is traded globally, 24hours a day on an over the counter market, meaning there is no centralised order book or pricing mechanism. The size of the FX market gives us a clue as to how significant a problem this could be. Global FX market activity was $5.3 trillion per day in 2013 (BIS Triennial Central Bank Survey 2013) and institutional investors account for 11% of that volume so approximately $590 billion is at risk of being mispriced each day. This could clearly be an underestimation in today's world because we are not taking into account any growth in FX activity since 2013, but this should definitely raise a huge red flag for all institutional investors.

Chart 2: Foreign exchange market turnover by instrument[1]

Net-net basis, daily averages in April



[1] Adjusted for local and cross-border inter-dealer double-counting, ie "net-net" basis.

Source: BIS Triennial Central Bank Survey.

Interestingly, looking at the breakdown of the daily FX activity by instrument shines more light on the extent of the problem. FX swap activity was again the most actively traded with 42% of the volume at $2.2 trillion. Spot activity stood at $2 trillion or 38% and Outright forwards accounted for 13% or $680 billion. If you compare those results with 2010, Swap activity dropped from 44% to 42% of the total volume while Spot activity rose to 38% from 37% and Outright forwards rose to 13% from 12% .The trend is towards more active trading. Spot and Outright forward activity totals 51% of the daily activity and these are the most sensitive to competitive and accurate market pricing so the most likely to be mispriced.

Institutional investors do not only have to grapple with the issue of the complexities around accurate and competitive market pricing. Their FX activity is often outsourced to a third party such as a custodian, prime broker or a middle office operations provider, possibly resulting in a more opaque process that is even more open to abuse. Relying on a third party to process all the FX activity efficiently makes it even more difficult to accurately identify the real cost of each FX trade. In addition the standard transactional FX associated with securities trades is normally a secondary trade linked to another asset so is more complex to identify.

All institutional investors need to take more control of their FX activity and clearly define and manage an efficient process rather than simply outsource it to a third party provider.

The Size of the FX Problem

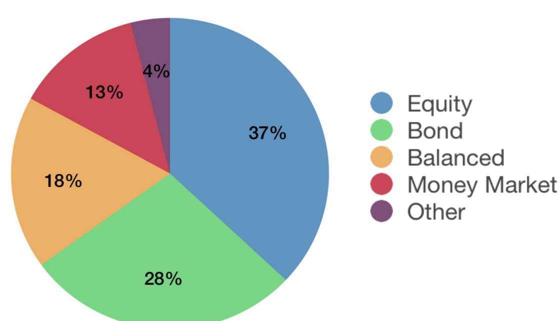
We have established that FX is an essential part of the business process to all institutional investors who invest client money internationally. It is an area where there is a history of mispricing and this does have a direct impact on the performance of the funds under management but how much does this cost the industry and individual investors? It is difficult to quantify the exact size and cost of the damage caused due to a lack of specific data but it is possible to make some qualified and well educated estimates based on official published data.

Table 1: Net Assets (EUR bn)

Category	August	% Change	End 2014
UCITS	7,970	n.a.	7,177
Non-UCITS	4,373	n.a.	4,139
Total	**12,343**	**-2.5%**	**11,316**

Source: EFAMA August 2015 factsheet

Chart 3: Net Assets by UCITS Type



Source: EFAMA August 2015 factsheet

The European Fund and Asset Management Association (EFAMA) regularly publishes data on the size of net assets in the European investment fund industry. Their August 2015 factsheet shows that European investment fund assets totalled EUR 12,343bn. The breakdown by type shows Equity funds at 37%, Bond funds at 28% and Balanced funds at 18%. This is a combined total of 83% of total assets or EUR 10,245bn. The next step is to estimate the % of these funds that are invested in international assets and therefore require FX transactions.

Table 2: Holdings of Debt and Equity Issued by Euro Area Residents and Held by European Asset Managers

	Securities other than shares (EUR billion)	Shares and other equity (EUR billion)
Euro area assets held by European asset managers	3,875	1,374
Securities/Shares issued by Euro area residents	16,715	4,498
Total share of European asset managers	**23%**	**31%**

Source: EFAMA Asset Management in Europe, June 2014

As seen from Exhibit 55 in the appendix of EFAMA's 7th annual review of Asset Management in Europe in June 2014, it estimates the total Euro area assets held by European asset managers to be EUR 5,249bn. This equates to 51% of the investment fund assets held in equity, bond and balanced funds so the remaining 49% or EUR 4,996bn is invested outside the Euro area. If we assume that a normal annual turnover for a portfolio of assets is 100% per year and that the FX is mispriced by a weighted average of 3bps on the total assets, that would equate to EUR 1.5bn per year in costs to the European fund industry. On a relatively conservative estimate, this is a significant amount of money lost to the fund industry and ultimately from the pockets of individual investors and future pensioners.

Another way to look at the size of the problem is to focus on the custodian banks whose primary role is to safeguard clients' assets but who also provide ancillary services such as FX pricing. Historically custodian banks provide this service as a principal and are able to generate profits from this FX activity when undertaking these transactions on behalf of their clients. It has been alleged that these revenues are excessive compared to market practice.

These profits could come from an excessively wide spread, or pricing the trade at a poor rate. Historically, it has been difficult to determine these profits on a trade-by-trade basis due to the lack of time-stamped trades. Practice does appear to be improving in the willingness to provide time-stamped data. Through expert analysis and advice, institutional investors, fund managers and pension funds can help ensure that their custodian banks and FX providers adhere to best FX execution practices.

Foreign Exchange is a hidden cost to institutional investors, asset managers and pension funds and their clients. Custodian banks are in a privileged position so it is vital that the buy-side take the appropriate action to mitigate these risks and regularly monitor the cost of their FX using expert analysis.

Establish Priorities for FX

Chart 4: What are the top three challenges you are currently facing in foreign exchange markets?

Source: TradeTechFX FX Industry Benchmarking Survey 2015.

In an environment that is constantly changing and becoming ever more complex, all institutional investors have to establish clear priorities to support the successful growth of their business model. TradeTech recently conducted a survey for its FX conference in July 2015, the FX Industry Benchmarking survey 2015. The survey was completed by 54 senior FX professionals made up of Heads of FX Trading, CEOs and senior management from leading asset managers and hedge funds.

The results clearly identify the challenges that face institutional investors. 76% said regulation and compliance was a key issue, followed by reporting and transparency at 50%. Much has been written about the ongoing regulatory change and its effectiveness and impact on the financial industry. Many participants have expressed their concern about the excessive additional administrative burdens and costs associated with implementing the various new directives. These do tend to fall unevenly and often unfairly on industry participants with smaller players bearing the brunt and being the most disadvantaged in terms of time, effort and % of resources required to ensure compliance with the deadlines. What is even more galling for them is that they were not the intended focus of the regulation in the first place and can hardly be defined as a systemic risk.

A detailed analysis is not required but a quick review of how the trends in regulation are changing FX might be helpful. In June 2015, The Fair and Effective Markets Review (FEMR) was published and although it is not a specific directive or piece of regulation, its objectives are far-reaching and it sets the trend.

It had three main purposes:

> *"First, it provides an analysis of the root causes of recent misconduct and other sources of perceived unfairness in Fixed Income Currency Commodities (FICC) markets. Second, it evaluates the impact of the significant reforms already completed or under way. And, third, it makes recommendations to fill remaining gaps."*

The most relevant section of the review is the policy recommendations highlighting the near-term actions to improve conduct in FICC markets. As far as FX is concerned, the relevant recommendations are:

"4 Launch international action to raise standards in global FICC markets

a. Agree a single global FX code, providing: principles to govern trading practices and standards for venues; examples and guidelines for behaviours; and tools for promoting adherence.
b. As part of that work, improve the controls and transparency around FX market practices, including 'last look' and time stamping;"

In its analysis of the root causes of all the recent market misconduct the FEMR concluded that one of the most significant factors was:

"Standards of acceptable market practices, particularly in bilateral over-the-counter (OTC) markets and less heavily (or un-) regulated instruments including spot FX, that were sometimes poorly understood or adhered to, short on detail or lacked teeth;"

Interestingly the policy recommendations concerning the remaining gaps left since the implementation of all the recent regulations include:

"Fourth, there is more to do to raise standards in global markets, including those for spot FX."

As highlighted in their recommendations above (4b) one of the major areas that needs improvement is "transparency around FX market practices" but it believes that the implementation of the Markets in Financial Instruments Directive II (MiFID II) will be an important piece of regulation to help resolve this issue:

"Transparency is likely to improve further over time with the extension in 2017 of MiFID II transparency rules to a wide range of FICC assets;"

There is some uncertainty surrounding how to treat Spot FX under MiFID II and in a recent public meeting held on October 19th, the issue was brushed over in reply to a direct question. Spot FX is not an investment instrument and is legally excluded but if 95% of your client business is transacted through the MiFID II mechanisms of best execution, it begs the question as to why would you not include Spot FX. The most pragmatic approach in this world of good conduct and best practice would be to implement the same high standard for all your business transactions.

Unfortunately regulation will remain on the radar and will continue to require the attention of all institutions involved in the financial markets whatever their size or nature of their business. On this occasion regulatory change demands more transparency around FX market practices and that is a direct benefit to institutional investors resulting in an improvement in fund performance and fee income. It will be a constant challenge but if managed and implemented correctly, with expert advice and support, best market practice creates a business advantage.

Why the Daily 4.00pm FX FIX?

At the heart of all of the recent alleged market abuse accusations is the aptly named WM/Reuters 4.00pm London FIX. It is used widely by institutional investors, fund managers and fund administrators primarily to satisfy the logistics of internal processes around pricing index funds. Historically, it has been held up as an independently verifiable and auditable source of prices for FX helping to meet one of the best execution criteria for buy-side institutions. It has never been viewed as a perfect solution by either the sell-side or the buy-side but over the years it has been indelibly written in to operational processes making it extremely difficult to change behaviour even though it has been discredited on a number of levels. The Financial Stability Board's (FSB) report on the progress in implementing FX benchmark reforms praised financial institutions in London for making significant improvements to the FIX including enhanced transparency. "Recommendations to support more transparency in customer pricing for fixing transactions have seen good implementation among the largest market participants and for the most used benchmarks, but elsewhere there is scope for further improvement," read the FSB report. However, market participants must be aware of the challenges and potential drawbacks of the London FIX.

Why does the London FIX have such influence on the markets and its participants? USD 9 trillion of assets is benchmarked against the MSCI Indexes and since 1993 these indices have all used the WM/Reuters Closing Spot Rates. The Citi World Government Bond Index is used by USD 2 trillion of assets and also uses the WM/Reuters Closing Spot Rates. Other Index groups tend to use the WM/Reuters Closing Spot Rates on a formal or informal basis. Asset managers need to rebalance significant assets on a daily basis and any material change in the constituents of the indices will generate directional trades in one or more currency pairs.

Until February 15th of this year, the fixing window was 1 minute (+/-30 seconds) but it has now been widened to 5 minutes (+/- 2 ½ minutes). The increase in the time period was designed to eradicate the opportunity for the manipulation of prices during the fixing process. In order to participate in the fix pricing, banks require asset managers to advise them of their required trades prior to the fixing window - often with a cut-off of 30 minutes before the 4.00pm window. Banks are therefore privy to privileged information opening them and the process up to charges of manipulation and collusion. These are being investigated but that aside, the London FIX is not the optimum time or method for asset managers to price their FX transactions.

Trillions of dollars are contractually tied to these rates generating billions of dollars of trades normally in the same direction particularly at the end of the month. Trading at the FIX, especially in the last few minutes becomes intense and often irrational as banks and investors fight to protect themselves against undue risk. Asset managers normally delegate the responsibility to match the London FIX price to their banks in return for a set basis point fee. As a result of all of these factors, the market bid/offer spread tends to be wider at the London 4.00pm FIX than normal market trading. More often than not the required trade flow is in one direction skewing the price against the clients' interest, adding an irrational premium to the price. In addition clients pay a fixed fee making this an even more expensive time to trade transactional FX. Pension funds, mutual funds and asset managers cannot afford to ignore this increased cost of FX that can amount to millions of dollars.

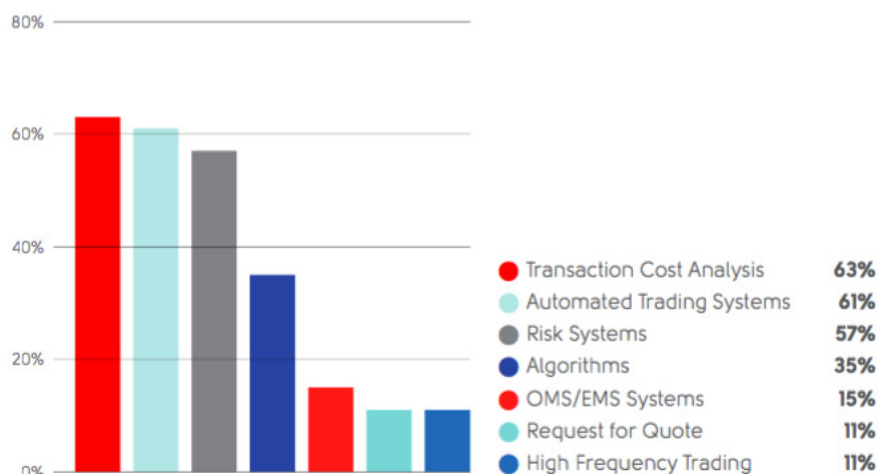
Although it is probably too soon to assess the impact of the new 5 minute pricing window, anecdotal studies point to a widening of spreads and an increase in the set fees levied by the banks in response to an increase in their risk premium.

To establish the true cost of trading FX at the London 4.00pm FIX, it is necessary to analyse the opportunity cost between the time of arrival of the FX order and the eventual execution at the London 4.00pm FIX. This would require more complex transaction cost analysis tools to calculate a Time Weighted Average Price (TWAP) for that day or for the relevant time period within that day.

In conclusion using the London 4.00pm FIX does not tick all the boxes for institutional investors who are looking for an ideal practical solution. If you have no contractual obligations to trade at the London 4.00pm FIX then it really makes no sense to pay the extra trading costs associated with the increased price volatility and risk premium. The best advice would be to change your trading process and become more cost effective and efficient benefiting your fund performance. If you are contractually bound to use the London 4.00pm FIX then take some advice on the best ways to reduce and monitor trading costs and look for ways to improve what is an expensive and irrational trading method.

The London 4.00pm FIX is flawed. It is not the best time, price or method to execute FX transactions. Institutional investors who are not contractually required to should not use it and those who are should do everything in their power to reform it or use an alternative solution.

Chart 5: What technology will you be investing in over the next 12 months?



Source: TradeTechFX FX Industry Benchmarking Survey 2015.

The TradeTech survey is a useful place to review some of the technology options open to institutional investors to meet their risk and compliance requirements while also improving their cost effectiveness and operational efficiency. 63% of respondents are planning to invest in transaction cost analysis, 61% are planning to invest in automated trading systems while 57% plan to invest in risk systems.

Transaction cost analysis (TCA) is a relatively recent concept as far as FX is concerned as traditionally its roots were in the equity markets. Originally it was implemented for compliance reasons but has evolved into a sophisticated analytical tool to enhance alpha, support trading practices and best execution policies. It is not surprising that recent events in the FX market are creating more of an impetus and bringing TCA into the spotlight. As we have already discussed, it is more difficult to achieve accurate cost analysis in the FX market as a result of its global OTC characteristics. It is not as simple as following the equity model but rather a requirement to look for smart ways to use TCA in FX.

What is the definition of transaction cost analysis and why can it be useful to asset managers? Transaction cost analysis is the study of trade prices to determine whether trades were arranged at favourable prices – low prices for purchases and high prices for sales. The main challenge of TCA is to determine whether a price was high or low in relation to the market conditions when the order was placed. TCA is therefore a method of establishing the effectiveness of portfolio transactions or in the case of this paper specifically FX transactions.

Transaction cost analysis (TCA) is essentially a rating of the spread between two possible prices and the difference between those prices is commonly called "slippage". Slippage is effectively another word for cost and this cost directly impacts the performance of the portfolio or fund.

The first number is the price of a particular FX transaction if it were executed at the prevailing market price at the time the manager decided to place the trade. The second is the actual price of the transaction including any commissions and trading costs.

As a result of the market mispricing there is greater scrutiny of market transparency, the quality of FX pricing and the efficacy of the London 4.00pm FIX. Institutional investors and asset managers need to review their trading practices and use the data available to make informed changes. FX TCA is an essential business function that quantifies the extent of the problem, the deficiencies in the trading process and the actual cost of the pricing strategy. If used correctly TCA will help to deliver better trading results, reduce costs and improve fund performance while supporting best market practice. Current market trends are driving a constant demand for better execution, cost efficiencies and improved performance. Smart TCA can support this drive for change by understanding the intricacies of FX and working closely with the asset managers to implement innovative solutions.

Technology is a key element in the development of new trading venues such as algorithms, Electronic Communication Networks (ECNs) or even agency trading platforms but more work and research is required to make these realistic solutions. Institutional investors and asset managers need a competitive advantage and the use of TCA on a stand-alone basis is necessary to clearly identify the problem but it is not a solution in itself. An experienced consultant that understands their objectives and the market conditions can use TCA to isolate the problem and recommend relevant and viable solutions for the specific circumstances. A powerful combination to achieve future success involves the capture and analysis of data that can support the decision making process to maximise the benefits of the trading strategy to support an efficient investment process.

FX Transaction Cost Analysis is a pre-requisite for all institutional investors and asset managers to ensure transparency and best market practice. The results of this analysis can be used as a powerful tool in the decision making process to implement change and innovate and achieve maximum benefit from the preferred trading strategy. This is not just a box ticking exercise but can have a positive impact on fund performance, fee income and profitability.

Recommendations for Regulators

Since the financial crisis regulators have focused their efforts on systemic risk and the need to improve best market practice for both the buy and sell sides. Their approach has not always delivered the intended outcome on time and has often resulted in unintended consequences for the market. It is worth making a few high level general points on possible ways to improve their method of implementing new regulations.

- Regulators should make best efforts to understand the mechanisms of the market.
- Establish a rapport with market participants on both buy and sell side to better understand where their issues lie.
- Communicate clearly and in a cohesive manner any new regulations and directives to the market using local associations and trade bodies as points of contact for follow up seminars and workshops.
- Explain the reasons behind the changes and how regulators intend to use any data collected to improve market operations or the risk environment.
- Don't operate a "One size fits all" methodology to impose new regulation. Differentiate requirements as to size and type of activity and use a gradual implementation process. Start with systemic risk institutions and move through the spectrum.
- Clearly state and stick to timelines to avoid confusion.

On a more specific basis regulators should ensure that new market regulation is implemented in the most practical way without excessive disruption to market efficiency and operations. Best market practice is of paramount importance and is the responsibility of both buy and sell side but there is little point in imposing new processes that are impractical and onerous.

Looking at MiFID is a good example: In MiFID I, EU parliamentarians and regulators gave great leeway in defining best execution. They required both buy-side and sell-side firms to:

- Develop and disclose execution policies and procedures to explain to their clients what best execution and order handling meant to them; and
- Show how they were taking all reasonable steps to implement/follow their own guidelines.

MiFID II imposes a higher standard of accountability — firms must now show that they are taking all sufficient steps. The FCA's July 2014 Thematic Statement on Best Execution and Payment for Order Flow provides greater clarity on what is "sufficient." In short, both the buy and sell sides are required to leverage quantitative methods and implement new compliance workflows to "demonstrate" to investors that they are actively monitoring what they disclosed, how they are communicating with their clients and how they are treating their client orders.

Higher standards of accountability to deliver the highest quality of client service and protect client interests is key in the new world but yet again this looks like another prime example of "one size fits all".

- Quantitative methods will not be appropriate for all institutions and therefore exceptions should be made depending on the nature of the investment strategy and the types of instruments used.

- Compliance workflows are an essential tool but ensure they are practical from an investment standpoint and that the client understands the salient points and the need for a monitoring process.

- Handling client orders efficiently is in everyone's best interest but again clients need to understand the process and why the changes are to their benefit.

- Transparency is probably one of the most important elements of helping to eradicate market abuse but it is a complex area and needs practical solutions particularly in FX and Bonds.

- If investors cannot access satisfactory sources of data to monitor pricing quality, then there are questions as to how they are they able to prove that they are protecting their clients' interests. In FX, banks should be required to provide clients sufficient trade data including timestamps for independent verification. After all, it is their data.

- Banks have certainly improved the transparency around their client FX trading processes but more can still be done especially if investor clients are captive to specific custodians. There is still much confusion around the various methods that banks and custodians use to process client FX trades and this needs to be clarified. All banks should be required to clearly disclose their FX trading policies so investor clients can independently assess and choose the most appropriate for their purposes. There should be no captive FX processes unless there is full and timely disclosure of pricing data and time stamps for independent verification.

- Independent FX TCA should be a requirement for all buy and sell side institutions to meet their due diligence responsibilities and to protect the interests of their clients. Underlying asset owners, such as pension funds, should also be required to take responsibility for ensuring their pensioners are receiving the best possible returns on their funds.

- The London 4.00pm FIX is a difficult one for regulators to control or reform but they should ensure that the underlying methodology is documented and validated. Implement a process to verify that the 4.00pm FIX is being operated in line with the methodology. There should also be a regular review as to its effectiveness and recommend relevant updates. All pricing data should be published for independent review and analysis. While there have been marked improvements in transparency around the London FIX, firms should be aware that it does still have flaws. Furthermore, a number of other global FIXES have yet to make the same progress and reforms that London has made. As such, firms need to be cognizant of this.

Summary of Advice for Asset Managers

- FX is an essential ingredient of any asset management business but managers should not view it as a necessary evil.
- FX is an OTC market traded globally providing extensive depth of liquidity at certain times of the trading day but lacking the transparency and clarity of an exchange traded market.
- Operational processes are often opaque offering various opportunities for mispricing.
- Regulation and risk are major challenges but do not have to be an obstacle or barrier to do business. Use them as an opportunity and vehicle for change to upgrade and improve your business model, operational efficiency and ultimately profitability.
- Review internal trading strategies and practices to comply with regulatory requirements, business objectives and best market practice.
- Use MiFID II to improve transparency and clarity in the FX process, specifically the trading strategy and market practice with banks. Create a competitive advantage by demonstrating to clients their best interests are protected.
- TCA is not just a box ticking exercise, but a tool to understand and quantify trading issues and problems.
- Use TCA data to make informed decisions to improve trading strategies and practices to reduce trading costs and efficiencies.
- Access and utilise consultants with FX market expertise, experience and knowledge to maximise the benefit of new technology and trading venues.
- An efficient FX trading process adds value to fund performance and is a competitive advantage in increasing AUM and a global distribution strategy.

Conclusion

Regulation has switched its focus from systemic risk to transparency and best market practice. Recent scandals and market abuse allegations prove that this is a welcome change of direction particularly as far as the FX market is concerned. It is not only important to re-establish the credibility and reputation of the operating mechanics of the FX market but to ensure that the buy side and their underlying clients are treated fairly and receive a value for money service.

The pursuit of transparency and best market practice will deliver direct benefits to Institutional investors. Mispricing of FX transactions is an unknown hidden cost and a drag on fund performance so by eliminating this there is an automatic and immediate uplift in fund performance and ultimately fee income and profitability. Clients will in turn receive a higher return on their assets and an improvement in the quality of service through better transparency and market practice. That can only be good for building strong business relationships.

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