Optimising the trade allocation process

ECB FXCG

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Optimising the FX Trade Allocation Process

- The Global FX Division (GFXD) recently completed an analysis looking at the “Future of FX” to assist members in identifying the future trends and drivers of change within the FX market
- The work identified several evolving themes including the changing FX Market structure and the nature and role of market participants
- The GFXD analyses highlights several areas across the FX lifecycle that are responsible for a 17% increase in costs since 2020
- These themes raise potential concerns on the long term outlook for liquidity and service provision
- Greater understanding of the drivers and implications of the changing roles for market participants helps ensure the continued fair and effective functioning of FX market

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- The GFXD scoped out parts of the FX trade lifecycle where industry workflow inefficiencies are adding to the following service costs
  - Compliance, Regulation & Capital costs
  - Transaction costs
  - Technology & Operations
  - Risk Management (incl. credit, compliance and market risks)

- The FX trade allocation process (TAP) can suffer from a number of inefficiencies creating market fragility and resulting in increased settlement, compliance, credit , capital, operational and market risks

- GFXD has published the whitepaper on “Optimising the Trade Allocation Process”
  GFXD - Optimising the FX Trade Allocation Process (Jan26)

- The whitepaper highlights the challenges and risks created from notifying allocations post-trade, and provides a series of recommendations to:
  - Raise the level of awareness on how this process has evolved, highlighting the challenges, risks, and inefficiencies
  - Highlight the points of friction and identify areas for improvement to promote greater efficiency and transparency
  - Provide a list of recommended practices to improve the TAP process for market participants

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- Block trading is a vital process that supports fund manager fx trading. A single FX (block) trade is allocated into many underlying fund accounts

Pre trade allocation – trade allocation at the time of execution, provides transparency of credit, capital, compliance needs and transaction costs

Vs

Post trade notification – trade allocation via middle office requires semi-manual/manual input , provides an opaque view of credit, capital, compliance and transaction costs

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Trade Example:

Trade Request: Competitive quote for 1mth FX swap – Notional EUR3bio (net)

Trade Allocation: Actual Notional (gross) EUR 33bio (bought) vs EUR 30bio (sold), Middle office receive trade allocation 1-3hrs post-trade

Post-Trade Allocation Process - Risks and Challenges		
Risk Considerations	**Key Challenges**	**High/Med/Low**
1. Market	Competitively priced at mid-market/inside mid-market (at execution)	Medium
2. Credit	Opaque view of credit exposure to underlying accounts. e.g., Block trade (net EUR3 bio) at execution, post trade allocations received gross (+33bio-30bio) may exceed credit limits.	**High**
3. Capital	Opaque view of capital cost and exposure to underlying accounts	**High**
4. Settlement	Unknown trade volumes booked inside/outside CLS increases Settlement Risk	**High**
5. Operational	New account set-up is req'd to occur within accelerated settlement cycles, risks missing CLS cutoff times, requires an additional 4-step manual confirmation/settlement process - Opaque view of actual number of transactions	**High**
6. Compliance	Trading on new accounts prior to set-up, creates an opaque understanding of underlying counterparty, adding transaction monitoring and market risks. Unapproved c'partys require trade cancellation/novation	**High**

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- 5 key recommendations are made to assist in reducing risk and improving operational efficiency

1. **Trading & Execution** - Market participants should provide full details of trade allocations pre-trade and prior to execution, to allow for executing bank to accurately price for related costs and risks of the trade
2. **Align with FX Global Code** – Work with market participants and supervisors to highlight TAP inefficiencies, challenges, and risks, raising awareness of process deficiencies to market participants and establishing a list of best practices that align with the Principles of FX Global Code
3. **Transaction Cost Evolution** – With evolving industry structure and dynamics, ensure industry participants are increasingly aware of the transaction costs and impact of inefficiencies across the trade life cycle
4. **Onboarding** – Prioritization of new account opening/onboarding prior to trading, to assist in mitigating the incidence of trade breaks. Post-trade account set-up challenges are heightened by accelerating settlement cycles and can result in payment and settlement delays
5. **Operations** – Reduce settlement, credit, operational and compliance risk by providing pre-trade allocations. Automated pre-trade allocations processed via straight-through-processing help to mitigate these risks and align with Principles 35 and 50 in the FX Global Code for reducing Settlement Risk

Buy Side Perspective

- Post-trade allocation creates cost and risk for LPs
- Most institutional FX flow is predictable before execution
- Some is genuinely uncertain. Break accounts exist for good reason
- But the bulk isn't uncertain. It’s perhaps just not communicated because of entrenched workflows
- Nothing makes it expensive not to
- The standard is set at the margin: least sophisticated buy-side, most accommodating LP
- Code adoption ~10%. We can keep writing papers, or we can ask why.

Questions for discussion

1. If pre-trade transparency is widely recognised as best practice, what prevents it from becoming the default and what role should codes, supervisors, or infrastructure providers play?

2. Is the persistance of post-trade allocation primarily a technology problem or an incentives problem across buy side, sell side and vendors?

3. As settlement cycles accelerate across asset classes, can post-trade allocation models adapt or do they become a source of systemic fragility?

4. In periods of market stress, do current FX market structures, including post-trade dependencies and opaque allocation practices, amplify liquidity strain?