The quest for FX transparency: coping with the realities

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Rachael Hoey, director, global product management, treasury services, RBC Global Services, examines the factors driving the costs of FX execution and the issues to address in choosing a benchmarking model.

Eroding margins and regulatory demands for increased governance are driving investment managers to take a long hard look at the processes and costs of foreign exchange execution. Greater transparency is being sought to more accurately determine the costs of managing securities-related FX and improve governance and oversight.

Assessing FX execution costs is not simple. For most institutions, market cost does not equate to the interbank dealing rates quoted on Reuters or EBS. These are merely indicative rates for market makers involved in 'market sized' deals – generally considered to range from \$1 million to \$10 million. When trade sizes and flows are not of a market making size, then the associated trading costs are relatively higher.

There are also process and oversight costs in managing FX to consider, relating to operational management, risk and governance. Operational costs include the capture and validation of all the securities trades over the trading day to determine the accurate FX requirements for trading, the avoidance of over or under trading of FX, filtering currencies into the correct currency pairs for effective base currency and cash management, correct matching of value dates to ensure accurate settlement and timing to settle cross-border securities, and meeting cut-offs for currency cash movements to ensure securities settlement.

There is the cost of managing risk in relation to observing FX trading limits and controlling counterparty risk when trading FX with market suppliers. Controls and processes to avoid expensive errors or omissions, particularly in volatile markets, are another source of risk related cost, as is the management of FX exposure and trading risk stemming from quickly and correctly defining FX exposure, positions and settlement dates for the correct base currencies for each fund.

In terms of governance, the time and cost of exercising control over FX exposure and execution should not be underestimated.

So how best to determine your FX costs and ensure transparency? Accepted wisdom is that transparency goes hand in hand with benchmarking. But benchmarks only possess real value if funds and their clients are clear on exactly why they are benchmarking, what they are benchmarking, and against what rates.

Rule one: be clear on why you are benchmarking. Are you gauging execution performance, or looking for a 'bigger picture'? The two are not the same. In order to benchmark execution performance, an FX rate at the point of execution is required, whereas if you are trying to benchmark the total risk performance, for example, then your model needs to extend to benchmarking from the point at which the securities trade is executed to the point of FX execution.

Rule two: be clear on what you are looking to benchmark. When it comes to constructing a model, the usual goal is to measure deviation in performance from an ideal price – that is, a price or rate that reflects the market at the point of execution.

Today, most models use one (or a combination) of approaches to define the 'market rate', the most popular being the hi/lo, end of day, opening and WM fixing or similar. While these options are used to assess FX execution performance, they are limited since they do not reflect dealt market rates but are merely approximations.

In selecting and applying a benchmarking model, there are several factors to take into account. Does the model or benchmark reflect the time of securities trading and the actual market rate at point of execution? Are the rates actual rates that have been dealt? Does the model measure consistency?

A benchmark should fit your trading activity. If it is concentrated during a particular period of the day, how relevant are the hi/lo or opening/closing price? FX rates are constantly fluctuating, so benchmarks that average out prices will not be sufficiently accurate to produce data that gives a true reflection of price deviation at the point of execution.

It is important to review the rates used by a particular model. If they are approximations of rates dealt throughout the day, they will not represent actual dealt rates. The WM 4pm GMT fixing is in fact an algorithm of trading either side of 1600 hours, and the hi/lo are either the bid or offer at the highest and lowest points of the day, ascertained after market close.

When it comes to the consistency of performance, popular methodologies often fall short. The benchmark rates are often divorced from the actual point of execution, and thus do not measure how consistently the FX prices achieved deviate from the 'market rate' at the point of execution. The use of proxies to determine execution rates only obscures real performance at the time of execution, particularly in periods of high market volatility. In the case of the hi/lo, actual spread recorded on less volatile days is generally less than those taken on highly volatile days, and any performance measurements derived from this will inevitably be inconsistent.

For a benchmarking model to reflect a client's unique trading patterns, it must possess immediacy at the transaction level, tracking deviations against a real-time benchmark, reflecting the FX execution rate in the market at the precise moment of execution.

All FX is not equal and all benchmarking models are not the same. And it is this fundamental point that fund managers and their clients must accept and manage as part of their quest to improve the oversight and management of their FX activities. ■