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Traiana's Jill Sigelbaum: Mitigating Risk in FX

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Special Report: Scandianvian FX Markets

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Traiana's Jill Sigelbaum: Mitigating Risk in FX

Jill Sigelbaum, global head of foreign exchange and alliances at Traiana, talks to *P&L*'s Galen Stops about the growing credit risks in today's electronically traded spot FX market and how technology is both the problem and the solution.

Galen Stops: How do you view Traiana's role in the financial services industry today?

Jill Sigelbaum: There are two principle roles. We are a provider of post-trade solutions, offering operational efficiency services through messaging, allocations processing, confirmations, matching and life cycle event handling across asset classes. Our other focus is on credit risk mitigation, where we help firms manage their pre- and post-trade credit limits and operate the credit checking hub for the swaps markets.

GS: What are the main problems around credit that you see in the FX market right now?

JS: One of the primary issues in the market today is that prime brokers (PBs) and banks with bilateral credit relationships are over-allocating credit to ECNs to enable their firms, and their clients, to trade wherever they want.
As well as over-allocating credit to the ECNs, PBs are also over-allocating to the executing brokers (EBs) to ensure clients have sufficient access to liquidity. This is a real problem because of the way it works – if they set up a relationship with a new client who has a limit of $250 million, and this client wants to trade with 10 banks, they might allocate $100 million of credit to each EB or ECN. Now the client effectively has a $1 billion line – four times the amount of credit out there.
In the past no one worried about these issues because FX trading was much slower, so people could keep track of activities easily and the risk of a client utilising all the limits across venues was virtually nil.

GS: And now?

JS: Now the market is very concerned about it. First of all, it has become expensive for banks to over-allocate credit and more importantly, it's a huge risk factor for them because of algorithmic execution. If a model goes wrong, every single credit line could get filled before anyone can blink an eye. This obviously has implications if the client gets into financial difficulties.

GS: Could this over-allocation also cause problems for the executing brokers?

JS: Because many banks are executing electronically on ECN venues for their bilateral trading, they share the same set of problems with the prime brokers. In addition, the EBs have a slightly different issue.
When trading with PB clients, they have a specific carved-out credit line that they've been allocated by the PB as part of the designation notice process, which they must monitor and honour legally.
If the carve-out limit gets breached, they have to stop the client from trading. Some EBs don't track tri-party credit in real time, therefore they may not be able to quickly stop the client from trading on their own execution venue. If the limit gets breached, then the PB has the right to reject the trade to the EB. As a result, the EB now has trades with clients that it may not have a credit relationship with.
No one worried about these breaches in the past because they could call the PB and get a credit extension or do a risk-reducing trade. But in today's electronically traded and credit sensitive market, it becomes a big risk for the EB to take.

GS: So if a prime broker needs to stop its client executing on various platforms, how do they do this?

JS: Historically there was no automated means to stop clients trading if their model had gone wrong or a limit was breached – it was a manual process.
Without a kill switch and the appropriate monitoring tools, the PB would have to log onto every ECN to stop the client from trading. It's even more labour intensive with the EBs because they have to make changes through the legal designation notice process, which means any changes have to be faxed, emailed or couriered over, and the EB then has hours to comply. This is all changing.

GS: This is where you think Traiana's CreditLink can help?

JS: Yes. In 2011, we started working with leading PBs to deploy real-time limit monitoring and kill switches to the major multi-dealer FX trading platforms.
CreditLink gives PBs the ability to monitor their clients' credit risk and trading activity across multiple ECNs and single dealer platforms in real time, with kill switches to nearly every major ECN. We are now building the same kill switches to SDPs.
CreditLink also automates the designation notice process so that PBs can dynamically change credit lines – they send a message to the EB which can be adhered to immediately.
This is completely integrated with the CreditLink monitoring tools, so if the EB is using it when the PB changes the credit line, then it will automatically change the credit line that is in its CreditLink monitor.

GS: How many of the platforms have you built kill switches to?

JS: CreditLink is live today with eight kill switches to ECNs.

GS: Are you planning for more?

JS: Yes. Electronic FX trading has grown on SDPs in recent years and now represents a key area of technology risk in global FX markets. We've started building kill switches to the SDPs, which in turn helps the PBs by giving them control over credit and where their clients can trade.
This kill switch also gets triggered when the EB is using CreditLink to monitor their designation notice limits and that limit gets breached. We're also extending the capability to bilateral trading for banks executing electronically.

GS: So this eliminates the risk of over-allocating credit?

JS: We started the process of addressing the risk with a blunt kill switch – trading for the client is on or off. But we're working on a more sophisticated approach now.
We're rolling out the ability to rebalance credit in a dynamic way with connectors to all the execution venues, with rules dictating how a credit line gets carved up and how it gets rebalanced across venues, which in turn solves the old problem of having to over-allocate credit.
For example, if the available limit is $200 million the PB might set it up to carve it evenly across four trading venues so there's $50 million at each. With the rebalancer, they can set it up so that if any one platform reaches a pre-determined limit utilisation, then the total credit available to all the venues will be rebalanced.
In this example, if one of these venues gets to $40 million of the $50 million limit, it will take credit away from the other venues to provide more at the one actually being traded on. This rebalancing allows the PBs to allocate the actual credit limit, rather than over allocate.

GS: Does the rebalancing happen in real time?

JS: It can rebalance constantly in real time based on the utilisation of the credit lines and the triggers input into the system, depending on the limitations of the ECN.

GS: When is this being launched?

JS: This capability is live with central-limit order book swap execution facilities (SEFs) in rates and credit default swaps (CDS), and this autumn we're introducing the same capability into FX as well. We're also working with the ECNs to build the ability to message credit and utilisation in preparation.
CreditLink is integrated to the credit APIs of five ECNs already ahead of the rollout.

GS: Are there any other new elements that you're working on to build into CreditLink?

JS: We believe that there are currently insufficient controls in place to protect the banks, and the market in general, if an automated trading system goes wrong.
To counter this, we are developing trade pattern monitoring, which enables banks or clients to set up trading parameters which identify anomolous trading beyond these parameters, and triggers a warning or automatically stops the trading.

GS: Is this designed for the PBs?

JS: When we initially started building this, yes, we thought that it was for the PBs, because they're the ones that see all the trading. But the EBs have similar exposures and responsibility to ensure that the clients who are trading with them are trading safely. There have been many incidents in the market where a client or a bank algo had a bug and the counterparty banks relied on spotting it manually before it breached any credit lines. They may not have hit any limits, but they were generating very large volumes and could have racked up losses. It could have been serious.
These incidents illustrate that the client, EB and the PB share responsibility to protect from these types of risks.
So PBs, EBs and buy side firms all benefit from this functionality.

GS: What sort of parameters does it use?

JS: We're using simple parameters to start, focusing on magnified differences in how someone trades.
For example, if a client usually trades 100 times a day and suddenly they trade 100 times in 10 seconds, the kill switch can be activated or alerts triggered. Similarly, because a zero being added to every order is a real fear, we'll look at notionals over time and if the profile suddenly diverges, the system can deliver a warning or stop trading. All of these parameters are set by the banks themselves – we just provide the ability.

GS: What if a client wants to trade outside of their profile?

JS: We've worked closely with the PBs on the different features of the system. A big concern was the risk of cutting someone off from liquidity who had consciously changed their trading pattern.
As a result, we changed the design of this feature so that the PBs can allow clients to profile themselves so that if they change their trading pattern, the onus will be on them to go in and change their profile before they activate their new model.

GS: What would be the attraction of a system like this to the buy side, though?

JS: The buy side is also concerned about credit and they are already among the largest users of CreditLink in the rates and CDS market as a result of the shift to mandated central clearing. We see this only growing in the future.

GS: You talk about the risk of electronic trading models going wrong. Is the evolution of trading technology introducing new risks to the FX market?

JS: As more flow goes electronic and more client types go electronic, it is creating different risk for the industry. I believe that credit monitoring hasn't evolved at the same pace as execution.
The buy side early adopters of electronic trading happened to be some of the most sophisticated technologically, but now you have many client types trading electronically through an API, and I am not sure that everyone is aware of the level of exposure that exists in the FX market.

GS: But the FX spot market has been largely trading electronically for some time, are the risks associated with this truly greater now?

JS: The world is changing and trade execution is becoming faster. Latency is everything, and even a few years ago electronic trading was not as fast as it is now. This means that if something goes wrong, a firm could build up huge positions in the market in an extremely short period of time.
Also, in the past people didn't worry about the credit of the bank, but that's not the case now. I think that a combination of the changing nature of trading, the lack of confidence in banks' credit and regulatory scrutiny is heightening awareness of these risks.
Another evolving trend is that trading is growing on SDPs compared to ECNs.

GS: Do you expect this trend to continue?

JS: I believe that an increasing amount of trading will take place through liquidity aggregators and these aggregators are pooling SDP flow. Some of them also pool ECN flow, so it may be that a model develops where there are multiple layers and, depending on relationships and liquidity pools, maybe it will help the ECNs grow. It depends on the strategy of the ECNs because in the past they have felt competitive with the aggregators, rather than complementary.

GS: Does the greater use of aggregation mean more algorithmic trading?

JS: I think that the writing is on the wall with regards to that. There are more execution venues and aggregators, and there is increased pressure on firms to achieve and demonstrate best execution.
Remember that for most regional banks their FX business is a corporate business driven by their clients. So when they go to hedge their positions they have the same challenge as asset managers in that they want to get best execution.
In the past they'd call their broker to find the best price, but now they're using aggregators. It's possible that in the future only a handful of banks will be price makers and everyone else will be a price taker, and these takers will be using electronic algorithms to get the best price.
I think that firms will increasingly trade through algorithms that break up their order, execute each piece at the best price they can get and then put it all back together at the end.

GS: Away from the spot market, CreditLink also acts as a pre-trade credit hub for SEF trading?

JS: Yes, CreditLink helps our clients and futures commission merchants (FCMs) comply with rules under Dodd-Frank, which mandates pre-trade screening of all orders entered into SEFs.

GS: What was the biggest challenge to getting CreditLink live as a credit hub?

JS: The biggest issue was getting all the different SEFs and FCMs to connect and test prior to the deadline in mid-February. Since then, over 650 buy side client organisations have managed their pre-trade clearing certainty using CreditLink, for over 72,000 trading and clearing accounts. We're now connected to all the major SEFs, clearing houses and 16 FCMs.

GS: With a mandate for clearing non-deliverable forwards (NDFs) expected soon, will it be easier to set up a hub for FX after having done it for rates and credit?

JS: We are already live with FX NDF support to prepare the industry. It is easier in FX because it's our core market.
GS: Given that it's your core market, are you working on any new initiatives in FX?

JS: Our newest initiative is in asset management post-trade workflow. We are upgrading our Allocation Service to support a newer style of trading.
In the old world, asset managers had one post-trade workflow: they executed a block trade and they then followed up by allocating that block trade to their banks where they have a bilateral credit relationship.
They might execute across 20 banks and they would execute a few trades a day per currency pair and then allocate them across many funds.

GS: How has this changed?

JS: In the new world, asset managers are being asked by their investors to prove best execution. As a result, many of them are taking on liquidity aggregators or algorithmic execution systems to prove that they are sourcing the best prices.
By doing that they create a different problem – their post-trade workflow wasn't built to process the higher volumes or work across a large number of venues. So we've been working now with a few large asset managers and some of the aggregators to streamline the STP of that workflow to the banks and do the confirmations.
The other challenge that the asset managers have is where they used to have one post-trade workflow processing allocation, whereas now they have four.
In addition, there is the one that I just described, where executing through an aggregator breaks the workflow.
In the past, asset managers didn't like to use PBs because they try not to concentrate all their credit in one place. But now they want more flexibility in terms of where they execute and so they are taking on PBs for some of their flow so that they have the freedom to execute on anonymous ECNs.
For these asset managers, the trades that are executed through a PB will have different post-trade workflows to those not going through a PB.
Then there are the global asset managers who have to report under European Market Infrastructure Regulation (EMIR) – that's a third post-trade workflow.
The fourth is around NDFs and options, which soon may have to clear.
As a result of all these changes, their world has become very complex in the last year.

GS: Is this drive for best execution going to continue to shape the FX market?

JS: I think that need to demonstrate best execution will mean that the use of algorithms to trade is just going to grow and grow, until we're left with a smaller group of banks that are price makers and everyone else will be a price taker.

GS: Will we see more non-bank market making?

JS: That's another part of the market that's changing, some of the big liquidity providers will be the large high frequency trading firms.

GS: Will we see greater cooperation between HFTs and the banks?

JS: That's a tricky question because it depends on the banks. Some of them are very anti-HFT, while some see it as valuable. I think that the prevalence of HFT firms in the FX market will grow.

Jill Sigelbaum is on the management team of Traiana acting as the global head of Traiana's foreign exchange business. She is also the global head of alliances, the partnerships of Traiana's products and services across all asset classes.
She joined Traiana in 2003 and has over 20 years of experience in sales and marketing of technology products to financial institutions in the FX and derivatives sector.
In previous positions, Sigelbaum has run global sales for financial software companies, covering front-, middle- and back-office solutions for FX and derivatives.