


Prof. Harald Hau

Harald Hau is Professor of Finance at the University of Geneva and holds an SFI Senior Chair. He received his PhD in Finance from Princeton. Before joining the faculty in Geneva, he was a member of the faculty at ESSEC and INSEAD. His research interests lie in the areas of international finance and financial stability.

Discriminatory Pricing of Over-the-Counter Derivatives

In 2009, the governments of the G20 decided that to improve market liquidity and reduce financial instability all standardized over-the-counter (OTC) derivatives contracts should be centrally traded on electronic platforms. This reform also included the largest financial market: the worldwide foreign exchange (FX) market. In April of 2016, global daily OTC FX turnover was USD 5.1 trillion.¹ For comparison, the daily New York Stock Exchange group volume turnover was USD 42 billion during the same period.²

SFI Professor Harald Hau, together with fellow researchers Peter Hoffmann and Sam Langfield, European Central Bank, and Yannick Timmer, Trinity College Dublin, shed light on the pricing mechanisms at work in the FX derivatives market in their paper *"Discriminatory Pricing of Over-the-Counter Derivatives"*. Their research shows how request-for-quote multi-dealer electronic trading platforms (RFQ-platforms), as envisaged by the G20 reform project, will reshape the OTC FX market, benefit SMEs, and improve overall market stability.

How does the OTC FX market currently operate?

In the current OTC FX market there is no obligation for dealer-banks to publicly disclose quotes and transaction prices; therefore real-time prices are not readily available. This allows dealer-banks to offer identical financial services at different prices to different non-financial clients. To better understand how this opaque market functions and prices are fixed, the researchers use data covering more than half a million trades executed between 2016 and 2017 in the EUR/USD currency pair. First, they find that the most sophisticated non-financial clients (25 percent) are charged spreads of 2.5 pips, or less, over the market mid-price, whilst the least sophisticated non-financial clients (25 percent) are charged spreads of 30 pips, or more. Second, dealer-banks exploit the general lack of transparency in the OTC FX market and earn information rents. For example, client orders that are placed in the direction opposite of recent price changes incur higher spreads than orders placed in the market direction.

Third, there are client-dealer relationships at play. Non-financial clients pay higher spreads when trading with their relationship dealer-banks, and non-financial clients that are important to their dealer-banks receive discounts. Finally, despite the absence of central clearing in the FX derivatives market, credit risk is not priced.

Where does the future of the OTC FX market lie?

The technology required to meet the objectives of the governments of the G20 is available in the form of RFQ platforms. On such platforms, non-financial clients post their requests and dealer-banks then compete against one another to provide the best price. The data used for the study reveal that the usage of RFQ platforms is not yet mainstream, as only 12 percent of all clients use RFQ platforms, but that such technology allows less-sophisticated non-financial clients to benefit from the same financial deals than their more-sophisticated counterparts. First, the discriminatory spread markup for less-sophisticated non-financial clients virtually vanishes on RFQ platforms. This result holds despite the fact that dealer-banks are still aware of the identity of their non-financial clients. Second, trading on multi-dealer RFQ platforms helps non-financial clients reduce dealer-banks' market power in cases of asymmetric FX price adjustments and eliminates discriminatory pricing.

What are the overall consequences for non-financial clients?

Over the past years, RFQ platforms for OTC FX deals have become increasingly popular. This trend reduces search costs and opacity frictions, gives rise to pricing competition, and allows firms, essentially SMEs, to find customized financial products. Such platforms allow non-financial clients to better hedge their cash flow related to international business and at a lower financial cost. Overall, trading on RFQ platforms provides improved execution quality for these firms. This greatly enhances the attractiveness of FX risk hedging and contributes to a reduction of financial risk in the real sector.

¹ Bank for International Settlements (2016) "Triennial Central Bank Survey—Foreign exchange turnover".

² <https://bit.ly/2JLxIVZ>



**David Mellor**

David Mellor works in Global Market Development role in the Thomson Reuters Transactions business. He joined Thomson Reuters as part of their acquisition of FXall in 2012.

"RFQ" Multi-Dealer Electronic Trading Platforms Eliminate Discriminatory Pricing

The research paper *"Discriminatory Pricing of Over-the-Counter Derivatives"* by SFI Prof. Harald Hau, Dr. Peter Hoffmann, Sam Langfield, and Yannick Timmer confirms Thomson Reuters' view that trading foreign exchange (FX) on a request-for-quote multi-dealer electronic trading platform (RFQ platform) is the optimum way to execute for all types of clients—regardless of their sophistication level—as price competition between providers effectively eliminates discriminatory pricing.

Thomson Reuters has been a crucial partner to the FX market throughout that market's evolution, which has seen it move from phone trading through single-bank platforms to RFQ platforms, and now incorporates more sophisticated execution methods. The common thread in this timeline is that each development has made it progressively easier for the end user to trade in competition and to get better pricing. Trading on RFQ platforms has experienced huge growth as the FX community has become more aware of the benefits of trading with all your existing providers in a structured and consistent manner.

In addition to the competitive pricing benefits of trading on a RFQ platform demonstrated in the research paper by Hau and coauthors, clients trading on such a platform also gain significant efficiencies in many areas of their execution workflow. Key functions such as regulatory reporting, transaction cost analysis, and straight-through processing can all be provided by a single vendor alongside a trading platform. This linkage of the pre-trade, trade, and post-trade workflow reduces the number of partners you have to work with and reduces risk. This in turn improves efficiency and drives productivity. Some RFQ platforms even offer seamless execution for multiple products across both regulated and unregulated liquidity pools, allowing users to easily comply with new derivatives legislation (such as FinfraG, MiFID II, and Dodd-Frank). Complex order management functions such as trade netting and allocations can also be automated, allowing traders to focus on higher value activities.

Traders should look for RFQ platforms that provide transparency with regard to their operational procedures so that they fully understand the process by which trades are formed. Independent RFQ platforms that are neutral and un-conflicted offer additional benefits to traders. By not taking positions, making markets, or having any bias regarding the direction of currency movements, these trusted platforms allow traders to execute with confidence knowing that the information on their trades will not be used in any way against their interests.

One of the few remaining hurdles we see to clients' deciding to adopt a RFQ platform is the apprehension that their relationships with provider banks will change. It is crucial to recognize that implementing a RFQ solution is not the end of the traditional sell-side-to-buy-side relationship. A RFQ platform is merely an extension of a bank's distribution. RFQ platforms and banks have partnered to deliver this solution to the buy-side community since the former's inception.

