

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

5 DERBY STREET
LONDON W1J 7AB

TEL: 020 7493 0173
FAX: 020 7493 0190

Conflicts of interest in the FX market: A round-table discussion with Neil Record (Record Currency Management), Mark Tennant (JP Morgan Chase) and Ian Battye (Russell Investments). Held on Monday, February 8, 2010 at Watermen's Hall, 16-18 St Mary at Hill, London, EC3R 8EF, from 12:30-2:15pm.

Are pension funds being raided by their custodians via uncompetitive rates in foreign exchange transactions? This once little known problem was discussed and debated at a recent CSFI round-table.

One speaker began by laying out the central issues. Previous thinking assumed that the market for foreign exchange – one of the largest and most liquid in the world – was nearly perfect, efficient and transparent. Given these conditions, it should have been nearly impossible to charge unfair prices for foreign exchange. However, in a number of recent studies/audits some custodians, who carry out all the necessary FX transactions on behalf of their clients, were found not to have secured the best price.

One audit, in an attempt to determine if a fair price was obtained, collected the deal tickets for a given time period. Because the tickets were not time stamped - only day stamped - the analyst looked at the range of deals across a day and ranked them from best (0%) to worst (100%). The expected outcome – given fair pricing – was a spread of 50%. What the study revealed were averages of 60, 70 and 80% which translated into the pension fund being 20 basis points worse off per deal than they should have been. For the client in this particular audit, that amounted to £900,000 pounds over the course of the year. Another speaker – using similar methodology – conducted a study that came up with almost the same results.

A recent example was the Calpers/Calters suit against their custodian bank (State Street) in which it was alleged that the pension funds had been overcharged in currency trades by \$56 million since 2001. In this case and others the implication was that pension holders, worldwide, could be worse off by billions of dollars per year. This had, as noted by another member of the panel, alerted other pension funds to the issue although he was not aware of much movement yet.

One speaker felt that this demonstrated an agency/principal problem that was indicative of a fundamental (and invisible) structural mistake in the market. He felt it would be best addressed by ensuring that principals and agents were distinct; prohibiting exclusive arrangements, i.e. a custodial bank would not use its own FX dealing room. Another panellist noted that they had encouraged their internal funds to take up this model to ensure 'best execution' but noted that a lack of awareness persisted among fund managers.

It was also pointed out the problem did not just revolve around total cost. One of the main issues was a lack of transparency. What often happened was that custodial services could be offered at a lower price because of the profitability of foreign exchange trading. The overall savings that could come with greater transparency may not – overall – represent very large savings.

Another speaker pointed out that it was neither surprising nor particularly shocking that custodians made a profit from FX trading. Global custodians had come into being because the investment market had gone global. They put their capital against the risks of settlement not happening, as well as collecting dividends.

He stated that between 1991 and 2000 asset managers had, in fact, paid very little attention to FX (given the bull market). But he took issue with some of what had been asserted by the other speakers. Many custodian banks now took instructions to net transactions over three reference points during the course of the day and this provided a bench-mark price. He also felt that an increasing number of trades followed this regime, as did almost all large pension funds, particularly given a flat or falling market. So while he agreed that up until 2001-02, when the market was not being closely scrutinised, abuse did happen, he felt that it was no longer an issue.

He also pointed out that custodian banks dealt with very sophisticated investors who would not be 'duped', and that the model he outlined above would be a far better solution than inserting another agent into the process, thereby increasing costs.

Other members of the panel noted that recent evidence and studies did not point to an improvement in the rates secured. One speaker felt that it was not enough to insist on time stamping, for example, as that did not address the underlying, skewed incentives. He also highlighted the fact that FX rates varied depending on size and access. For example, someone buying a flat in Spain would receive a much worse exchange rate than a custodial bank. Increased competition would bring prices down across the board.

Again, however, the same speaker observed that while the structure of pricing may change – perhaps custodial banks were paid too little for what is an expensive service and clients were paying too much for FX as an offset – overall costs may not be greatly reduced. These issues were similar to some of those addressed by an earlier CSFI round-table on equity research when the question of unbundling was discussed. The question remained, would it secure a better deal or end up being a more expensive model?