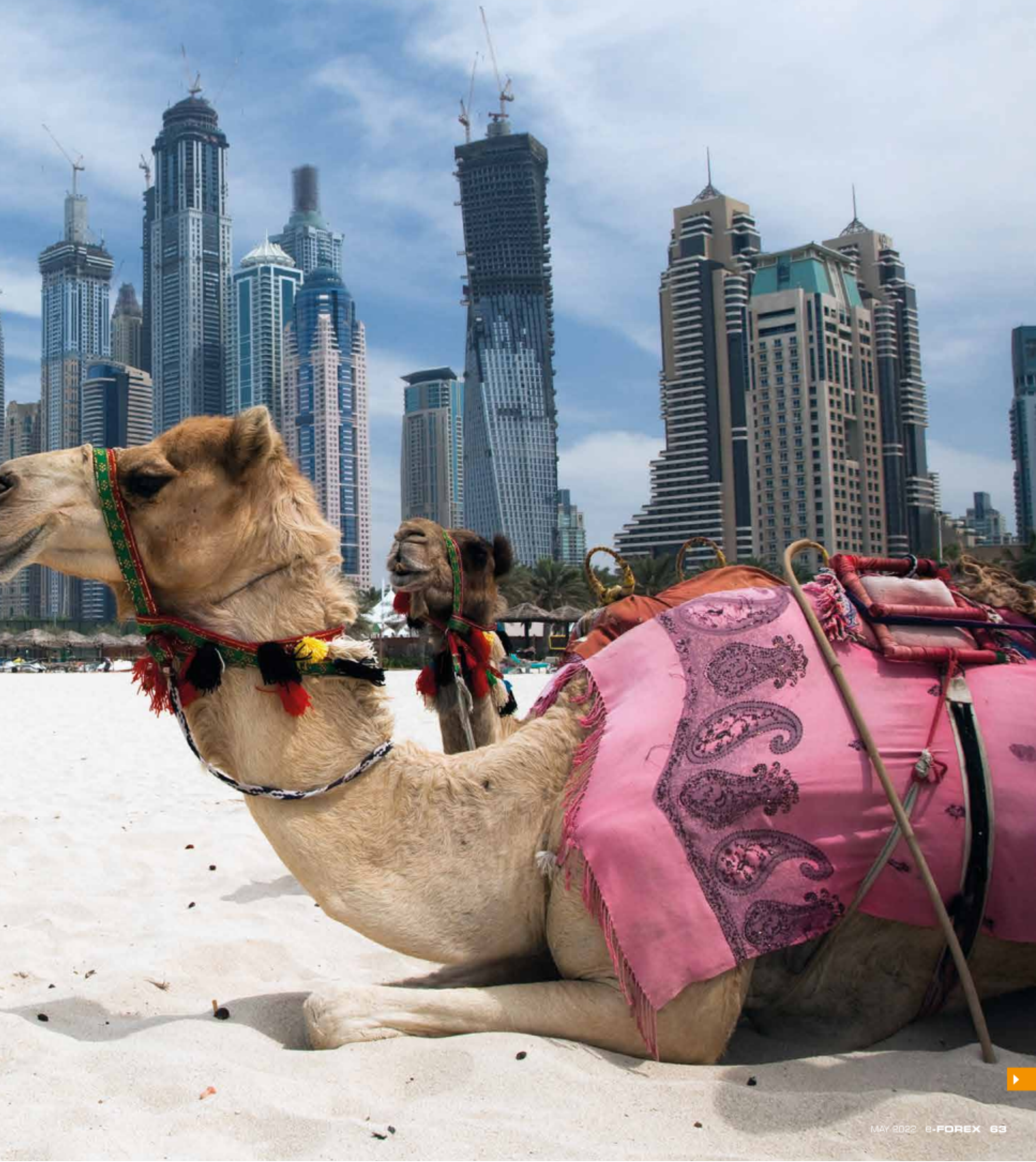
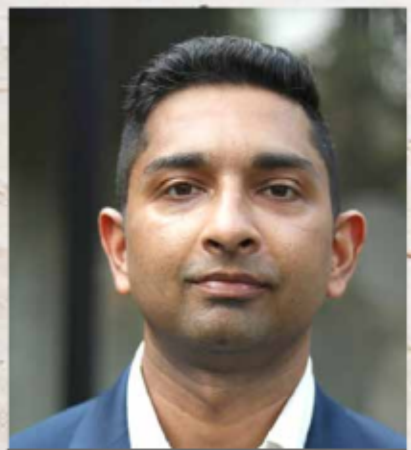
REGIONAL e-FX PERSPECTIVE



Exploring the changing face of Electronic FX in the MENA

Vivek Shankar investigates digital transformation across the MENA region and the role that electronic FX workflows are playing in this trend.



Vivek Shankar

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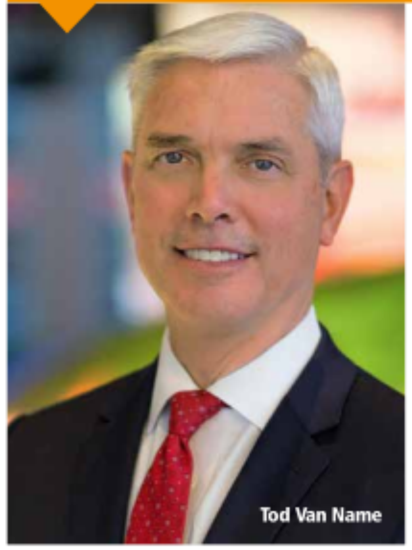
Tod Van Name

The MENA region has long been a net importer of goods, creating a natural need for stable FX services. Regulation and the influx of foreign investors are changing long-dominant trends in the region. Add to this mix COVID-related shocks, and it is easy to see why the region is witnessing a change in the way stakeholders interact in the markets. So what are some of these trends, and how are FX stakeholders reacting to them?

ELECTRONIFICATION AND CHANGING GOVERNMENT PRIORITIES

Electronification is perhaps the most obvious trend that has emerged. Tod Van Name, Global Head of Foreign Exchange Electronic Trading for Bloomberg, notes that electronic trading in the region rose by 33% in Q1 2022 compared to Q1 the previous year.

"An increasing number of organizations have expressed interest in adopting tools that enable them to trade more efficiently from remote locations to move flow that was previously negotiated over phone and email," he says. "Organizations have also been working to ensure systems are better interconnected with the goal of seamless deal capture for traders regardless of their location." Van Name also notes that third party partnerships are also rising, in contrast to the trend of deployed platforms that were the norm.

Meanwhile Husam Basaddiq, Director, Emerging Markets, Trading Solutions, Refinitiv, a London Stock Exchange Group business concurs that electronification is increasing at a rapid pace, especially in risk management. Refinitiv's FXall Volumes show a phenomenal CAGR of 46% in eFX trading volumes from 2016 to 2020 in the MENA region.

"We have seen more corporates looking for savvy risk management," he says. "Banks are now marketing these products to support and enable corporates to focus on profitability and minimize their FX exposure risks."

Basaddiq also points to MENA governments' changing priorities as a catalyst for FX flows. "The MENA region is awash with foreign workers who send money back home in their local currencies such as INR, PKR, PHP, etc," he notes. "As Middle Eastern governments push ahead with enforcing strict quotas of hiring homegrown talent, the outflow of FX requirements has started to reduce."

Imports, or rather the changing source of imports, are also impacting FX flows. "There has been an increase in CNH as more and more Chinese manufacturers that used to bill in USD now provide incentives if paid in their own currency," Basaddiq notes.

The push to electronification is bringing some predictable changes in FX workflows. Automation, for instance, almost always follows electronification, and the MENA region is no exception. "Automation is a key trend that is beginning to develop in MENA," says Van Name, "following the course taken in other developed markets. We receive many inquiries in this regard, particularly for small vanilla FX flow."

Basaddiq points to technological rationalization and vendor consolidation as other important trends affecting the market. "The rise of digital banks has put pressure on conventional banks to step up their digital journey or get left behind," he says.

Corporates are playing a leading role in the push for digitalization in the region. Demands for increased transparency in execution are compelling service providers to integrate and electronify execution workflows. As Basaddiq explains, "Corporates hold the key to digitization within the region. The requirement to prove best execution and ensure straight-through processing to avoid manual entry is a long-term driver of digital workflows."

Van Name echoes this sentiment by pointing out that TCA inquiries are also rising in the region. "There is also increasing demand to increase efficiency across the entire workflow, from front-office trading through to matching and settlement in the middle and back-office," he says.

CHANGING CORPORATE DEMANDS AND RISING FOREIGN INVESTOR INTEREST

As corporate requirements become more sophisticated, digital service delivery is impacting pricing and market data services. The demand for unbiased market data and a move away from bank data is particularly pronounced.

Ahmed Alsada, Business Director, Account Management, Refinitiv reports that spreads have shrunk for competitive reasons, and banks have adopted electronic trading workflows to build agility. " The demand is also driven by information flow and information availability," he says. " This has triggered the need for banks to have more features for presenting historical prices and recent news which complements trading activities."

Other features such as instant communication channels and greater insight into RFQ processes are high on corporates' demand lists. Aside from corporate demand, foreign investor preferences are also impacting FX workflows.

Alsada notes a few macro factors that have been responsible for these changes. " Some GCC countries moved from the MSCI Frontier Markets to the Emerging Markets index," he says. " That has opened these economies to more FDIs. In addition, the floatation of 5% of Saudi Aramco's equity has also attracted international investors."

Basaddiq points to increasing GCC volumes as evidence of foreign investor appetite. " On our Refinitiv Multi-Bank Platforms, around one third of GCC volumes are conducted out of the MENA region, whereas Europe contributes more than half of that volume, showing how much MENA has become part of the global economy," he says.

Bloomberg's Van Name notes that several price-making banks have steadily added GCC currencies to their offerings, indicating increased demand and sophistication in the region. " Middle East trading had been growing, and although the pandemic initially had a negative impact, we're seeing more firms considering alternative locations, like Dubai, for example," he says.

As growth and changing corporate demand force stakeholders to adapt, how is electronification faring with Gulf-region banks?

ISLAMIC FINANCE AND FX IN THE MENA

Islamic finance has experienced a surge in demand recently. The demands of Shari'a-compliant investment products meant that the rise of FX trading in the MENA region was complicated, to say the least. Islamic law prohibits interest, excessive risk, and the presence of gambling. While institutional FX rarely experiences these factors, the retail market doesn't achieve these goals. Brokers in the MENA region have reacted by offering swap-free accounts to cater to Islamic investors looking to avoid the presence of interest. Despite their popularity, some market observers question whether such products are truly Islamic. For instance, swaps and rollovers are essential to the way the FX market functions. In a swap-free account, the broker reframes the swap as a fee charged to the client. Thus, the act of transferring the swap remains, even if the account receives a marketing makeover that makes it Islam-friendly.

Shari'a compliance doesn't end with offering swap-free accounts. Institutions must demonstrate their commitment to Islamic law by setting up Shari'a supervisory boards (SSBs.) SSBs review products and related documents to certify them for compliance. Banks and institutions can offer only SSB-certified Islamic finance products to clients. Products such as futures and forwards often run into SSB-related hurdles since they contain significant speculative risk. Within the spot markets, short-selling is frowned upon. However, MENA governments do not ban these trading techniques outright. Instead, the onus is on the investor and the institution that declares its products as Shari-a compliant to demonstrate their commitment to Islamic law. While Dubai remains the region's financial hub for all things FX, Islamic Finance is increasingly gaining ground in Bahrain. The Kingdom recently created a license that enables institutions to offer fully-certified Islamic Finance products, and similar moves by authorities in the region are expected. Shari'a compliant FX products still remain low in number due to the FX markets structure. However, this hasn't impeded the growth of retail and institutional interest.

ELECTRONIFICATION AND CLIENT SOLUTIONS

Van Name explains that Gulf banks began their electronification journey well before COVID hit. The pandemic only hastened the need to adopt these solutions. Refinitiv's Basaddiq also notes that in the past only regional offices of international banks offered electronic trading. These days, electronic solutions from regional banks are common. "We have noted that banks are using their electronic trading engines across all their FX business, regardless of size, by adapting aggregation technology," he says. "This helps them ensure that tickets of all sizes will be captured within the platform." He also explains that smaller banks are now jumping on board the electronification trend as well.

THE STATE OF EXCHANGE-BASED FX TRADING IN THE MENA REGION

"In the coming months and years, we expect to see more growth in interest for new products within the region – such as crypto and Islamic products,"

The Dubai Gold and Commodities Exchange (DGCX) remains the MENA region's leading derivatives exchange, despite the launch of competing exchanges in Qatar, Bahrain, and Egypt. The exchange has played a critical role in the growth of FX trading in the region, along with promoting exchange-based trading. Introducing innovative products that cater to investor demand has been one of the reasons for DGCX's longevity. Les Male, Chief Executive Officer of DGCX, reiterates his organization's commitment to enhancing service offerings. "Last year, we launched the world's first Pakistani Rupee futures contract, which continues to attract interest amongst our members," he says. "Recently, it recorded the highest monthly trading volume since its launch last year; registering a combined total of 7,158 lots valued at USD 79.52 million during March 2022."


Les Male

Male also points to the signing of a strategic Memorandum of Understanding (MoU) with Global Islamic Financial Services (GIFS.) "This is in line with our vision to collaborate on the development of Islamic derivatives and commodities," he explains, "and introduce a series of Islamic future contracts and products that will bring value to the regional marketplace." Enhancing liquidity is one of every exchange's primary concerns and DGCX is working on introducing innovations that will satisfy investor appetites. The exchange is launching Israeli Shekel contracts in June 2022 to bolster liquidity and has tendered for members to apply as market makers on the DGCX platform.

Male believes these moves, part of DGCX's Designated Market Making Scheme, will incentivize trading activity and boost price efficiency. No discussion of trading contracts is complete without acknowledging the role cryptocurrencies have played in the markets. The UAE, where DGCX is based, has led the way in introducing laws that govern digital asset activity, something that has paved the way for DGCX to consider introducing crypto contracts. "As more guidelines and infrastructure continue to be introduced, it is certainly an area that interests us," says Male. "I can confirm that we are looking to launch Crypto future contracts, subject to relevant approvals. However, as a highly regulated exchange, these contracts would need to adhere to certain standards to ensure transparency and safety for our member base."

Male is equally excited about the potential for blockchain technology to improve transaction processing, transaction analysis, and increasing process efficiency. The current turbulence in the markets caused by global events notwithstanding, Male is positive about the future. Islamic products, in particular, have caught his attention. "In the coming months and years, we expect to see more growth in interest for new products within the region – such as crypto and Islamic products," he says. DGCX remains firm in its vision to offer its members innovative and value-added products. "We are confident that the DGCX will continue to play a leading role in driving innovation and growth in capital markets, offering our members the best possible trading experience," Male says.

Exploring the changing face of Electronic FX in the MENA

FX has been famously resistant to full electronification, when compared to its equity and fixed income cousins. So how has buy-side electronic adoption fared, specifically within the asset management and hedge fund space? " We have not only seen significant increases in electronic trading from asset managers and hedge funds," Van Name says, " but also in their use of more sophisticated trading methods such as algo trading for their largest tickets, while using voice or chat trading for more illiquid currency pairs." According to Bloomberg, MENA algo volumes rose 15% in 2021 and are expected to rise further.

RETAIL FX IN THE MENA

The high degree of technological investment in the Gulf markets and favorable tax regimes have led to notable evolution in retail FX. Mohammed Isbeer, Global Head of Brokerage Sales at Equiti Group, has kept a keen eye on these changes.

" The biggest evolution I've seen in the region has been the way governments are stepping up to regulate the markets," he says. " The region had suffered massively in the past two decades due to scams, and investor confidence was low. Regulation has changed all of that."

A recent example of regulatory innovation is the UAE Securities and Commodities Authority's (SCA) licensing procedures to establish broker credibility. These moves mirror similar global and regional regulation, from the UK and Europe, and Bahrain, Jordan and Kuwait.

Isbeer notes that FX has also become one of the most lucrative industries for long-term investment, something that goes against the grain of retail FX activity. Interestingly, a significant and growing portion of retail activity involves traders shifting from the crypto and digital asset markets.

The rise of NFTs, crypto, and DeFi platforms has put FX trading platform technology in the spotlight. Terms such as UI, UX, and gamification are gaining, pushing retail brokers to invest significant resources into their platforms on the front and back end.

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Mohammed Isbeer

" When talking about the new wave of crypto and NFT traders coming into FX," says Isbeer, " things like spreads or commissions are not at the forefront of their minds. They've become accustomed to wide spreads in crypto markets and demand exciting technology."

He points to enhancements in popular retail brokerage platforms targeting user experience, as opposed to product improvements, as evidence of the new retail trader's demands. Gamification is clearly appealing to the broader retail market, but it remains to be seen to what degree it affects the large investor's appetite.

Does the move towards gamification mean the region could see the rise of instruments like binary options?

Isbeer clarifies that gamification refers to the underlying technology, not products. " I'm completely against gamifying products such as introducing binary options or anything that looks like a gambling product," he says. " The user experience matters much more, such as enriching in-app interactions and offering a more engaging interface."

The mobile app experience is central to engagement from users. Isbeer notes that 75% of trading activity on Equiti's platform comes from mobile. However, the majority of trade volumes come from desktop traders, given their tendency to use EAs and conduct deeper due diligence on their trades. MT4 and MT5 remain the most popular platforms of choice.

Interestingly, institutional coverage accounts also witness high mobile activity, a trend that was perhaps born from COVID-related work-from-home measures.

Despite all of these innovations, regulation remains one of the primary growth drivers in the region. Isbeer points to technology and product as the other pillars of a successful retail brokerage. " The competition is fierce, but this is where I think all the investment and growth will happen over the next five years," he says.

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Husam Basaddiq

Given this increasing demand, there has been a significant shift in FX service offerings. Refinitiv's Basaddiq points to scalability and customization as key areas that his firm addresses. "The trading APIs facilitate the distribution of prices in different formats and validities," he explains. "The trading platforms also allow the traders to decide how they would like to manage their positions, automatically or manually, while always ensuring they can view the best possible prices by connecting them to liquidity providers."

Basaddiq also points to Refinitiv's decision to deploy platforms on client sites where the use of cloud technology is restricted. These efforts are over and above the company's efforts to support regional banks by offering them tech stack expertise.

Van Name highlights customized solutions that Bloomberg offers within emerging markets and products that increase transparency to centralize oversight capabilities.

"Communities are also looking at combining solutions with potential for anonymous matching, disclosed liquidity, and the ability to capture broker flow through tri-party ticketing all within the same market," he says.

While the push towards electronification is occurring in global FX markets, the MENA region has another factor that drives product choices: Islamic finance and the demand for Shari'a-compliant products. Is this demand currently significant?

"There is strong demand from Shari'a-compliant entities looking for FX products," answers Basaddiq. "Financial engineering and new structuring approaches have allowed these solutions to fulfill the requirements of any vanilla hedging solutions including forwards, swaps, and even options using Islamic principles."

He also notes that Islamic restrictions have kept Islamic bank products relatively vanilla, further boosting the attractiveness of FX as a staple revenue source. "Automating this flow makes sense to remove risk and increase profitability," he explains.

Van Name points to Bloomberg and its platform FXGO successfully supporting the electronic trading of Islamic deposits (Murabaha, Wakala, Mudarabaha, etc.) for several years. "We are now seeing increased demand for Wa'ad (Islamic Forwards,)" he notes.

WHAT DOES THE FUTURE HOLD?

If there is a common theme to the MENA FX market's future, it is electronification. Both Van Name and Basaddiq agree that the need for increased trade efficiency and risk management will spur increased electronic solution adoption.

As Alsada says, "More corporates and asset managers are ditching traditional treasury management via excel and voice in favor of technology to streamline workflows and make informed risk management decisions."

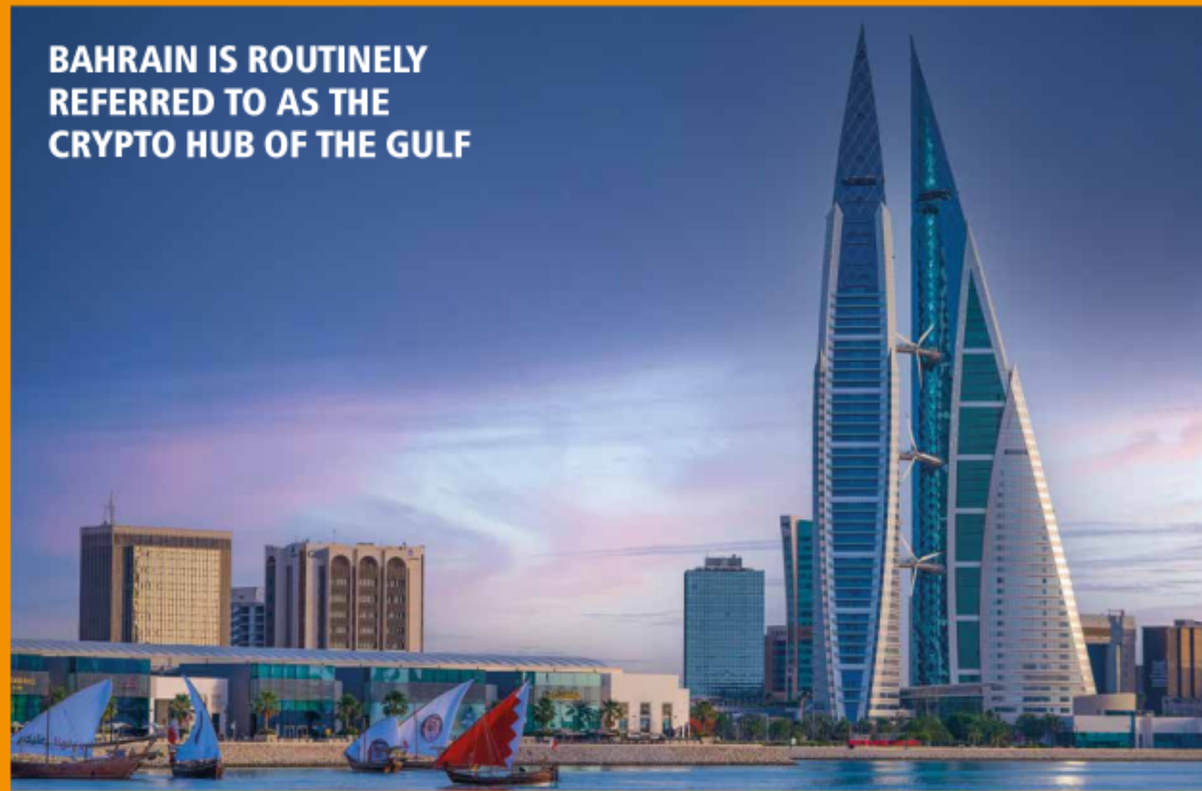
"Broadly, we see the MENA market continue to seek increased efficiency while reducing transaction cost and improving risk management," Van Name says. "Finding the right technology partner can help drive opportunities for both the buy and sell-side, without disrupting existing business practices and procedures."


Ahmed Alsada

"Some GCC countries moved from the MSCI Frontier Markets to the Emerging Markets index which has opened these economies to more FDIs."

BLOCKCHAIN, CBDCS, AND DLT IN THE MENA REGION

Blockchain technology holds immense promise for governments worldwide. MENA governments have actively pivoted towards embracing distributed ledger technology in a bid to improve investor confidence and streamline market operations. The United Arab Emirates has adopted an active role in positioning itself as a technological hub. In 2018, the country adopted the Emirates Blockchain Strategy, a set of policies that aim to position government services in line with the future. The launch of the e-Dirham and storing land records on the blockchain were some of the key initiatives in this regard.



Given Dubai's position as the region's financial hub, the government recently introduced much-needed clarifications involving digital assets. While banks on the ground remain crypto-shy, institutions such as Binance have been granted licenses to operate and sell digital asset products to retail investors.

Elsewhere in the region, Bahrain and the Kingdom of Saudi Arabia (KSA) have launched initiatives. Bahrain, particularly, has fully embraced the possibilities of cryptocurrencies and digital assets at a speed that left the UAE behind. Routinely referred to as the crypto hub of the Gulf, Bahrain boasts banking regulations for crypto and allows payment transfers through that medium.

This stance puts cryptocurrencies under the purview of the Central Bank of Bahrain (CBB,) not securities regulators as is the case worldwide. The KSA has several initiatives in place dedicated to studying the effect of blockchain on government processes. The rise of fintech-oriented services such as STCPay in the Kingdom is aiding a push towards DLT technology.

Despite this, blockchain and DLT solution adoption remain low in the region. There remains significant talk of CBDC launches amongst governments, with action expected within five years. Blockchain adoption is gaining ground in government services and wherever record storage is necessary. However, as far as payments and currencies go, the MENA region remains curious about DLT's potential. It remains to be seen whether the region's various initiatives will bear fruit.