FX: WHY BIG ISN'T ALWAYS BEST

WORKING WITH AN EXPERIENCED NON-BANK OPERATOR CAN WORK OUT WELL FOR THOSE NEEDING HELP IN THE FOREIGN EXCHANGE DEPARTMENT, SAYS **STEVE PRYOR** OF IFX.

The foreign exchange (FX) market is one of the oldest markets in existence, dating back to biblical times. It is also one of the largest, with a daily volume in excess of $1.3trn and it is estimated that the daily average FX turnover equates to more than 50 times that of the combined volume of the world's largest stock exchanges – New York and London. The market is also highly competitive, and typical spreads in the interbank market are wafer-thin.

London and New York are the dominant centres for FX transactions, followed by Tokyo, Singapore, Switzerland, Hong Kong and France. While North American principals are the most active with a 49% market share, compared with the UK's 21% and Japan's 7%, it is the London market that takes the dominant share, with an estimated 42% of the world's total daily volume. London has a larger share of business in both dollars and euros than its respective home markets. It is also the second most important site, after its own domestic markets, for the trading of the euro, Japanese yen, Swiss francs, and Canadian and Australian dollars.

The diversification and depth of the London market has much to do with its favourable time position between Asia and North America. Its language is that of the world business community and it has well-established historical trading links. As such, it is no surprise that so many international banks choose London as their trading headquarters, adding to the pool of expertise and the depth of the market.

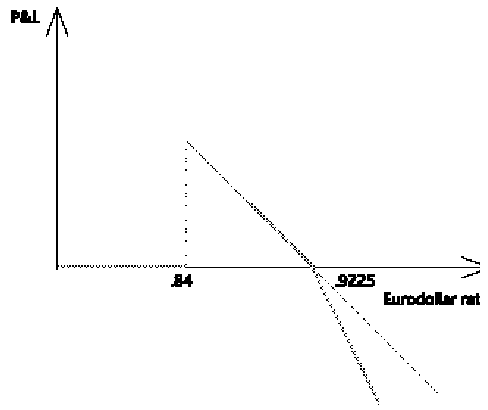
ROOM FOR NEW PLAYERS. For many years, the FX market was the exclusive domain of banks, but as it has evolved it has attracted other participants, such as investment funds, brokerage firms, institutions and individuals. As a result, non-interbank turnover in the FX market today accounts for almost 40% of all transactions.

Reasons for participation vary. Banks have a natural flow of FX business from their customers, who buy and sell currency according to their individual trading needs. The banks must then manage their own currency deposits, in the changing light of their customers' transactions, and decide whether or not to 'lay off' their exposure onto other banks. Many corporate treasurers will at some time or other have been involved in FX transactions. Even with the arrival of the single currency in Europe, UK-based treasurers are still exposed to FX risk as soon as they trade outside the UK, whether that be sourcing raw materials or exporting product. This could give rise to the need for sometimes sophisticated hedging, which can present pitfalls as well as opportunities. Because of their dominance in lending and because of the traditional closeness of the financial relationship, commercial banks have tended to monopolise the corporate market in FX. Although the inter-bank market has benefited from electronic trading for many years, non-bank corporates have tended simply to telephone one or more of their banks for a quote when they want to trade FX. This can be highly time-consuming, and not always cost-effective, and the banks are only too ready to reap the opportunities to make profit on the back of their clients' dealflow.

A recent survey of corporate attitudes to online FX trading by GTNews questioned 156 senior financial executives (mainly corporate treasurers) from 35 countries. Some 85% of the surveyed companies had turnover of more than $100m, and more than a half had turnover exceeding $1bn. Scarcely a fifth of them were already conducting FX transactions online, and, of this minority, only a third used a multi-bank platform, the majority relying on single-bank or in-house systems. Interestingly, and highlighting the demand for administrative simplicity and convenience, some 60% of respondents said they would implement online trading, once straight-through processing (STP) of transactions was available and reliable.

There are, however, other, more independent options to corporate treasurers and finance directors looking for ways to make their FX trading simpler and more cost-effective. For instance, IFX is one of the leading non-bank FX market-makers in London and one of the few which not only combines expertise in straightforward spot FX with OTC currency options and exchange for physical (EFPs), but also has a large precious and base metals trading desk. It is part of the publicly quoted Zetters Group. It has developed a sophisticated internet-based multi-currency trading platform, which enables the company to act as a wholesale liquidity provider directly to clients, offering not only spot FX trading, but also EFPs on the same platform, IFX Direct.

FIGURE 1
PROFIT/LOSS PROFILE



VALUE TO CORPORATES. It was precisely this combination of services which attracted the Italian-based SACAL to IFX. SACAL is a leading European aluminium processor and producer of aluminium alloys. It imports its raw materials denominated in US dollars, while it sells in euros and it sought IFX's assistance in managing its currency exposure and risks.

IFX, as one of the few non-bank institutions with dedicated customer support in vanilla and exotic options, was able to create a cost-effective strategy which put SACAL in the position where it had the right (or obligation, depending on the market) to sell the euro at .9225 against the dollar each month as long as spot remained above .8400 and below .9225. Spot at the time was close to .8700. The strategy consisted of a combination of reverse knock outs (RKOs) and reverse knock ins (RKIs) and was struck at zero cost to SACAL.

The structure, in essence, allowed SACAL to sell €1m euros each month at .9225, while spot was above .8400, and below .9225, or, alternatively, obliged SACAL to sell €1m each month at .9225, if spot traded higher than .9225 at a specific date each month, over a nine-month period. Obviously, this meant it was selling above the current level in spot and the current outright rates for each month, as long as the range was not broken, over the next nine months.

SACAL's risk was that spot moved above .9225 (where it would be selling greater amounts), but this level would clearly be beneficial to its underlying long euro position. The other stipulation was that the whole trade 'knocked out' (that is, the planned strategy no longer exists) at .8400. This was the company's worst-case scenario, as the spot would have moved against its underlying position and it would be left unhedged if this level traded. The advantage of the position was that, in the first month, there was little chance that .8400 would be hit and also that SACAL would already have managed to sell some spot at .9225 before the option knocked out. In the event, .8400 was a good level to choose, since spot has not been close to trading at that level and SACAL has benefited from selling at the high level each month so far. This trade will continue to benefit the buyer as long as spot fails to trade at .8400.

Ragioner Perego, Head of Treasury at SACAL, said: "IFX's team assisted us in developing a strategy that gave us a way to profit actively from our normal daily trading positions, without exposure to what, in our view, was unreasonable risk. This had the additional merit of reducing the dollar cost of our metal purchases. We are now looking with IFX at other ways of managing our currency exposure."

The largest global corporations are the natural clients of the largest global banks. However, smaller companies, however international their scope, do not always receive the appropriate quality of service from these banks. While, this type of FX strategy would not necessarily suit every company with FX exposure, it demonstrates the advantages of working with an experienced non-bank operator.

Steve Pryor is Head of FX Sales at IFX.
spryor@ifx.co.uk
www.ifxmarkets.com