# Fast forward for FX

THE FOREIGN EXCHANGE MARKET IS FAST-MOVING, RAPIDLY GROWING AND TECHNOLOGICALLY DRIVEN. **PETER WILLIAMS** REPORTS ON THE KEY DRIVERS.

## Executive summary

- While technology has already had a major influence on all participants in the foreign exchange market, to which treasurers are frequent visitors, its impact can only grow. Technology is also being hailed as one reason why volatility is at an all-time low, but would it be a risk management mistake to assume that low volatility is here to stay?

The foreign exchange market is growing rapidly and will continue to do so for the foreseeable future. Currently exceeding $2 trillion daily, volumes will surpass $3 trillion by 2010. According to a report by consultancy ClientKnowledge, electronic transactions represent a growing proportion of all trades, including more than half of client volumes (rising to over 75% by 2010). The technology infrastructure needed to enable and support those trades is now fundamentally interlinked with the infrastructure needed to support and render profitable non-electronically transacted trades.

As the spread on foreign exchange (FX) gets narrower, so banks become more reluctant to employ people to manage smaller FX trades. The solution is to move smaller trades onto the internet, so corporates aren't ringing up their banks to get quotes or execute deals for sub-$200,000.

As the volume of FX transactions increase, so does the desire for automation on both sides of the transaction. Increasing trade with emerging economies such as Russia and India has contributed to the rise in demand for FX services. And this movement in the real economy has more than compensated for any downturn in FX trading volumes as a result of the loss of the component parts of the euro. As well as trading for real commercial reasons, a growing share of FX dealing is driven by the growth in hedge funds and their eternal quest for returns.

Many treasurers have the classic pattern of a high-volume, low-value FX requirement. In many companies the treasury policy dictates that the organisation must seek competitive quotes whatever the size of the transaction.

Such a policy is time-consuming to exercise, particularly given the allied work of inputting the deal into the treasury management system. Many treasurers are therefore implementing automatic solutions as an add-on to their existing treasury management system.The goal is to replicate the FX trade more efficiently. The other key benefit of a system has to be straight-through processing, capturing the transaction within the accounting system.

From the banking sector's perspective, the challenges implied by the venues and modes of trading and distribution required to achieve and maintain profitability will force wide-scale revision of the infrastructure already in place at most firms and a limited lifecycle for any solution implemented.

The challenges of delivering robust solutions for key components of the dealing architecture are driving a tendency to buy rather than build, even if internal builders are used to combine heterogeneous systems and components.

Banks are dependent on their technology infrastructure not only to improve or protect net trading revenue capture but also to drive down human and processing costs. As a consequence, technology spends should be maintained and increased in this space, both in absolute terms and as a proportion of costs.

Today's spend of around $400m a year by the sell-side on e-commerce components will rise to nearly double that by 2010.

Justyn Trenner, Chief Executive Officer and Principal of ClientKnowledge, says: "The recent growth in the FX market is sustainable and will extend further over the next five years. Success for the sell-side will be predicated on its effectiveness in implementing interconnected technology, trading and distribution strategies – and firms will be penalised rapidly for failing to do so. Technology strategy and spend, therefore, will be at the heart of future profitability."

**LONGER-TERM MACRO IMPLICATIONS** The prospects for the foreign exchange market are strong. Driven by the potential for further alpha currency trading and the inevitable growth of several major emerging markets' currencies, the present phase of growth will continue unabated for the foreseeable future. Banks see their FX franchise as one of the most dependable of all banking businesses for delivering net shareholder returns. To achieve that, banks will need to manage their liquidity and trading more systematically and distribute against effective client segmentation. The only way to do this while keeping costs down will be through technology investment.

FX is perceived as a consistently growing and profitable business that becomes more dependent on technology, with the implication of fewer bodies in trading, sales and processing.

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### BOX 1. Who Does All This FX Trading?

Daily FX flow can be broadly divided into the following activity types:

- **Traditional market-making between interbank trading counterparties** (about 50% of all flows).
- **Traditional client activity, whether wholesale corporate and institutional, midmarket or retail** (about 25%).
- **Alpha, or absolute FX returns seeking flows, undertaken by dedicated leveraged funds, traditional money managers with specialist funds or proprietary desks at banks** (about 25%).

### BOX 2. Volatility Trends in the FX Market

Dino Kos, Executive Vice President of the Markets Group at the Federal Reserve Bank of New York, believes the FX market is a dynamic environment that is constantly innovating and evolving.

He says: "Not too long ago, most transactions were executed by one person calling another to negotiate a price. In recent years, technology has enabled an ongoing revolution in how we trade.

"An increasing number of tickets are now being executed through all forms of e-trading. Given this market's history of embracing technology, I see no reason to doubt that more innovations are on the way. The advent of white labelling and prime brokerage, while introducing some risks, is also bringing additional participants into the market."

The volatility of major FX rates is historically low. Volatility is typically measured either historically (how much an exchange rate has varied, on average, over a specified period, say one month) or option-implied (as extracted from option prices). The former is backward-looking, while the latter says something about expected volatility over the tenor of a contract and therefore has a forward-looking component.

Kos says technology has helped to reduce volatility: "Besides simplifying transactions, technology has enabled greater price transparency and a wider range of agents to participate in the marketplace. Newer players include smaller fund managers, individuals and so-called algorithmic traders – all of whom participate mostly or exclusively through e-trading systems, particularly in the spot market. Some of these newer participants may be more willing to provide liquidity at 'slower' times of the day. A greater number of participants trading more actively results in higher turnover, narrower bid-offer spreads and continuous pricing. With more participants supplying prices, the probability of price gaps in the spot market may be reduced, thereby lowering realised and option-implied volatility."

However, such low volatility might not last. "We don't know the direction of exchange rates or the speed at which they will move in the future," says Kos. "But firms should not be lulled into complacency by the recent period and assume that market volatilities – and risks – are permanently lower. Statistical risk measures, such as value at risk, may not capture the full extent of so-called 'tail events', even during periods of normal volatility. These measures are even more likely to paint too rosy a picture of risk when market volatilities are low.

"The stress-testing of positions and exposures is an especially important tool for sizing FX risks because correlations between the FX market and other markets are famously unstable. For this reason, we should be extremely sceptical of risk measures based on the status quo assumption that volatility will remain low."