

PERSPECTIVE

The FX Marketplace: Trends, Opportunities and Challenges



The foreign exchange marketplace is in a state of flux. The rules of the game are being re-written by the advent of new players and different ways of transacting FX thanks to technology advances. What are the trends in the FX marketplace and what opportunities and challenges do they present to the old and new market players?

The foreign exchange market is by far the world's biggest financial market. The last triennial survey in April 2004 put the volume of foreign exchange trading at US \$1.9 trillion daily. This is likely to increase to a figure of about US \$2.9 trillion daily by April 2007 (representing compounded annual growth rate of 15% a year).

Major trends driving the foreign exchange market

Addition of New Players

So called 'real money managers' (insurance and pension funds), hedge funds, proprietary trading desks and leveraged investors have become increasingly interested in foreign exchange as an asset class, as an alternative to fixed income and equities. Most active hedge funds follow one of the following strategies – macro strategy, carry trade or momentum trading. These are the most active class of participants in the market today and place huge directional bets on currencies. This has prompted sell-side banks to revamp their technology infrastructure completely so as not to get caught unawares by these savvy traders.

Proliferation in the Exchanges

In the good old days, almost 100% of trading used to take place on two matching engines, Reuters and EBS. This has changed. Technological advances have allowed the entry of many more exchange type places to offer their services to customers. To name a few – some of the largest trading banks have got together to offer a competing platform called Lava, which, unlike Reuters or EBS, is only used by market-making banks. Alternative exchanges include Hotspot FXi, EBS Prime, Reuters on CME, FXall and Currenex, etc.

Wide Adoption of CLS

CLS Bank, which was founded only four years ago, has found wide acceptance within the marketplace, with over 60% of the traded volume now being settled via continuous linked settlement (CLS). On 21 June 2006, CLS Bank International set a record for the value of payment instructions for currency transactions settled in one day: 381,872 payment instructions with a gross value of US\$5.35 trillion. CLS volumes count both sides of the transaction, so these volumes need to be halved for comparison purposes.

Growth in Algorithmic Trading

Algorithmic trading, as the name suggests, involves trading based on algorithms with no or limited user intervention. Algorithmic trading has been common in other asset classes such as equities but has picked up pace recently in FX. This has been facilitated by increased interest by proprietary desks and hedge funds that treat FX as an asset class. On the other hand, opening up APIs by liquidity aggregators such as EBS or FXall has also helped as it allows the hedge fund's algorithm to directly connect to the aggregator's system. Algorithmic trading accounts for roughly 7% of the turnover now and is the fastest growing segment.

Growth in e-trading

Technology is levelling the playing field between the wholesale banks that have the big IT budgets and smaller banks that are focused on specific regions or client segments. Electronic trading has significantly reduced the processing costs for FX. Banks can now offer white-label front-end systems, use cost effective pricing tools to deliver fast, customized prices and can offer white-label liquidity to its customers from large wholesale banks or multi-bank portals, such as FXall and Currenex etc.

Derivatives show stronger growth compared to cash instruments

The biggest growth in FX trading volumes has come from currency derivatives and swaps. The Foreign Exchange Committee, which is sponsored by the Federal Reserve Bank of New York, reported that average daily volume in over-the-counter foreign exchange instruments, including spot

transactions, outright forwards, foreign exchange swaps and options, totalled US \$577bn in April 2006, an increase of 31.5% over April 2005. Spot trading has also seen substantial growth led by accumulation of the reserves by Asian and Middle East central banks and increased retail trading.

Retail Trading

Technology has allowed retail traders to trade in FX in a big way. Efficient trading systems allow retail investors to trade amounts up to 50 to 100 times the margin placed for such trading. Dutch bank ABN AMRO launched its electronic platform market index in July 2006. This is based on a platform provided by a third party technology provider. Customers can trade with a margin of 2% with the initial deposit of just €1,000.

Growth in International Trade and capital flows

International capital flows have been a main underlying reason driving the growth in foreign exchange trading volumes. These take many forms, but essentially they can be classified into either direct investment or portfolio flows. As these investments churn, they involve currency exchange at each leg and also the overall return earned by the investors is greatly affected by the foreign exchange strategy adopted by the investors. Data between 1995 and 2005 shows that gross flow of financial capital between countries has trebled to reach more than 16% of

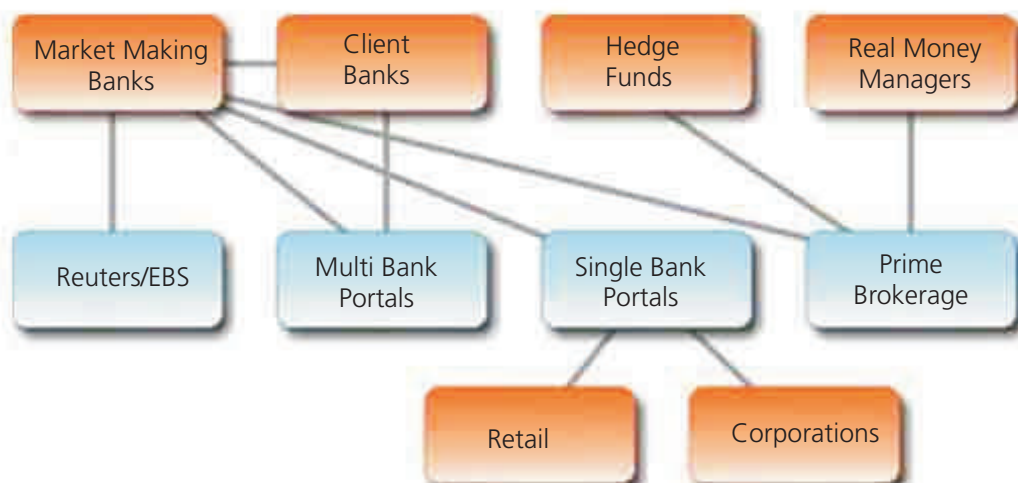
global GDP. On the other hand, trade flows continued to grow at a compound annual rate of 4.5% against GDP growth of 2.5% between 2000 and 2005, according to the WTO.

Emergence of the New Economies

As more countries make their currencies convertible on the capital account (such as Russia, which did this in July 2006), it provides a boost to trading volumes in those currencies.

Current structure of the foreign exchange marketplace

Foreign exchange marketplace essentially consists of the trading venues and the market participants. As discussed earlier, changes are seen in both these areas, which are altering the FX landscape. As shown in the diagram below, Reuters and EBS continue to be at the centre of FX trading even today, although their share has reduced over years as alternate liquidity providers have emerged. They are supplemented by multi-bank portals such as FXall and Currenex, single bank portals and by prime brokerage services such as EBS Prime. The participants in the marketplace include market-making banks, client banks, real money managers, hedge funds, corporates and retail customers.



Opportunities and Challenges for the Market Players

This fast-changing landscape presents many opportunities and challenges for FX market players.

- Due to the evolution of multiple venues, it has become important for key market players to be connected to all trading venues to remain on top of liquidity all the time. This requires keeping a tab on new emerging venues and making sure that the bank has connectivity to all important venues.
- Increased hedge fund participation has led to tremendous pressure on the response times on the computer systems. The response time has to be fast enough so that a sell side institution is able to take in a request, do a credit check, find the relationship pricing, produce a quote, create a deal and update the dealer positions in the shortest possible time frame.
- Algorithmic trading is a challenge for computer systems because its volume tends to peak, rather than being a constant flow, which makes it challenging to handle.
- With most trading becoming electronic, there is a need for activities such as credit checking and relationship pricing being done electronically, without manual intervention.
- Clearing and settlements are clearly heading the CLS way with one time investment required by banks for interfacing with CLS infrastructure.
- Market making activity, which is currently done by traders, is likely to move to algorithms with key traders focusing on proprietary trading.
- Electronic trading is the only possible way to service low-value high-volume retail customers profitably and banks need to make concerted efforts to move these customers online.

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