

# Efficiency and evolution – Fuelling growth in the FX market

The FX market is experiencing strong growth as it continues to evolve, and demonstrates increased efficiencies by successfully developing technological solutions and leveraging the advantages these bring. In the past five years this has led to more volumes from existing players and the FX market attracting an increasing number of new participants, who in turn have created more liquidity. ClientKnowledge, a UK based FX industry consultant, estimates that the rate of growth has actually doubled in the past 18 months from an average annual rate of 10 per cent to over 20 per cent.

## MARKET EFFICIENCIES

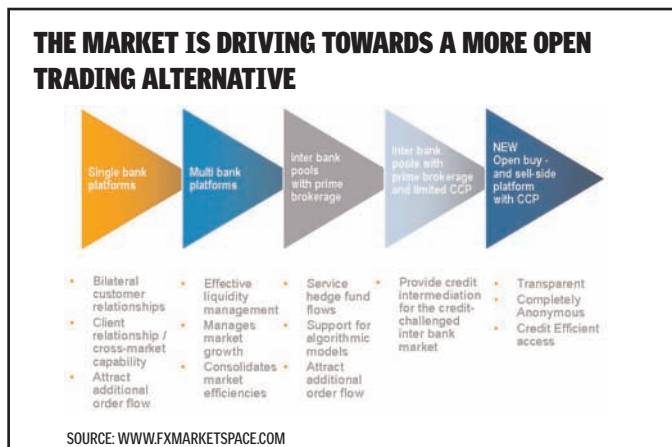
To date, Prime Brokerage within the FX market has delivered increased efficiencies for trading firms, enabling them to access liquidity from an increased number of counterparties. This has only created a stronger desire amongst institutional customers for the

industry to develop even more credit efficient and low cost trading environments. The deployment of technology has allowed institutions to trade and process these trades more efficiently; reducing the cost per trade and thus allowing smaller ticket business to be executed. The accuracy and speed of pricing engines to monitor liquidity across multiple pools and respond effectively has become increasingly paramount for all market participants. Furthermore, the advent of algorithmic trading and rules based systematic trading, employed by proprietary desks at banks, hedge funds and CTA's has created a significant opportunity to generate alpha. These technological



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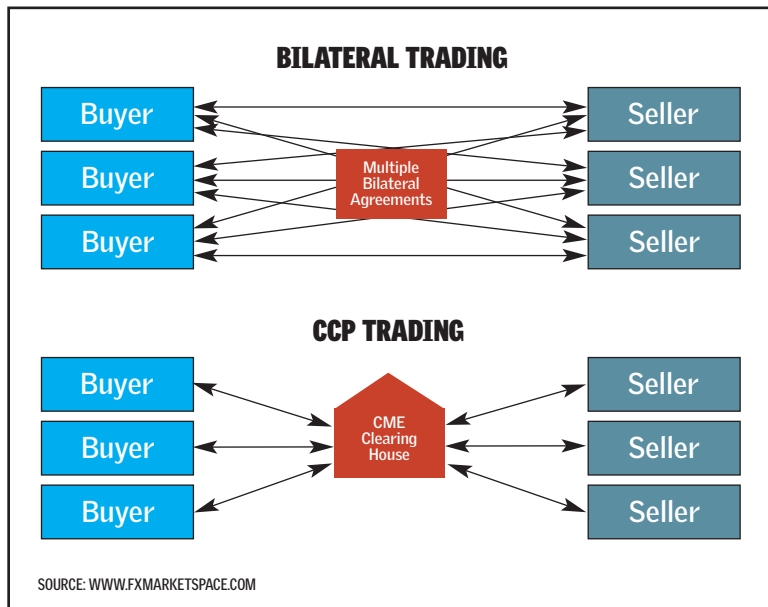
and credit efficiencies have resulted in the growth of FX as an asset class. Whereas previously FX was a by-product of other asset classes, more institutions have started to trade FX actively, attracted by the potential returns and 24-hour liquidity of the largest asset class in the world. As a result, the growth in volumes dealt by financial institutions has outpaced that of the FX industry as a whole. In 2004 the Bank for International Settlements (BIS) stated that the whilst the FX market as a whole has grown at a little over 10 per cent per



annum, trading by hedge funds, CTAs and money managers increased at a rate of 25 per cent per annum. The rapid increase in FX trading by financial institutions means that in 2007 it is estimated that they now trade approximately the same volume as the interbank market.

A new development in the drive for increased efficiencies provides for a new open buy- and sell-side platform using a central counterparty (CCP), where all customers have the same level of access. The FX market has discussed the potential for this type of trading platform for a number of years, where the efficiencies of exchange traded products are brought to cash FX, most importantly allowing all parties access to all prices, complete market transparency, complete anonymity and significant credit efficiencies. Finally this type of trading venue has been brought to the market in the form of FXMarketSpace.

**CREDIT EFFICIENCIES: BILATERAL TRADING VS. CENTRAL COUNTERPARTY (CCP) MARKET**



Traditionally, FX market counterparties have conducted bilateral trading, where buyers and sellers consummate deals. This model has several limitations which affect FX execution and increase the ‘all-in’ cost of trading. Firstly, counterparties need to identify

themselves, which provides the opportunity for organisations to price differently to different market counterparties. Secondly, institutions are unable to always access the best price in the market as they are limited by the bilateral relationships of their own or their prime broker. Thirdly, industry-wide costs of maintaining several hundred underutilised credit lines are being priced into transactions at an aggregate level. Finally, the lack of anonymous trading means that institutions run the risk of their trading patterns and styles being reverse engineered in the cash FX market, negatively affecting execution performance.

The CCP model, where an exchange matches buyers and sellers provides significant credit efficiencies. The Clearing House consummates transactions, becoming the buyer to every seller and the seller to every buyer. This results in institutions always having access to all the prices in the market. The CCP allows institutions to benefit from capital and credit efficiencies due to risk offsets between currencies, potential cross margining between FX cash and FX futures and multi-lateral netting between customer and

house positions, whilst the Clearing House determines collateral requirements. This substantially reduces the ‘all-in’ cost of trading. In addition, true pre- and post-trade anonymity is afforded to all market participants which encourages more trading.

**RISK REDUCTION: HERSTATT RISK VS. COUNTERPARTY RISK**

In the traditional FX trading model the seller accepts each buyer’s credit, the buyer sends payment directly to each seller and

the buyer accepts each seller’s ability to perform on the trade. Before the advent of CLS Bank which went live in 2002, each side of a trade was paid separately. CLS operates on a payment versus payment system and hence eliminates ‘temporal’ settlement risk known as

“Herstatt Risk”. CLS ensures that payments are not released until the other party fulfills their obligation. This is an important reduction in risk, but does not guarantee settlement: if your counterparty files for bankruptcy in the days prior to settlement (generally two days for Spot FX and longer periods for FX Swaps, FX Forwards and FX Options) the replacement risk is not protected against.

In the CCP market, once trades are matched, the Clearing House becomes responsible for guaranteeing settlement, eliminating replacement risk, and trades settle per initial contract regardless of the ability of the counterparty to settle. Hence the Clearing House minimises counterparty risk and guarantees settlement through the effective process of imposing more robust risk controls and collateralisation of market risk.

## **DELIVERING EFFICIENCIES TO DRIVE FUTURE GROWTH**

To date, market participants have demanded efficiencies of the FX market and by providing for these efficiencies the market has experienced growth. Future demand will drive future growth. New requirements continue to emerge, including the need for robust, scalable trade matching technology and more price transparency. The equity markets have already experienced significant growth, with increased electronic trading and algorithms allowing for more trading activity. It is likely that the FX market will follow this trend and will need to offer both minimum latency and maximum order throughput. Transparency will lead to the development of innovative and more efficient algorithmic trading models which will continue to evolve, placing further capacity issues on electronic venues. Interdealer platforms already report algorithms accounting for over 20 per cent of total trades and it is probable that this will increase and extend to more dealer-to-client trading. New hybrid clearing solutions for FX Forwards and FX Options will also emerge as customers continue to look for increased efficiency across multiple products. Institutions will increasingly focus on reducing cost disadvantages across the entire FX chain to boost their profitability.

Whilst it is expected that some consolidation in eFX trading platforms will occur it is likely that a few models with continued technology investment will persist, delivering benefits to address specific customer segments. As is already happening, there will be less distinction between buy- and sell-side organisations in the financial institutions space. It is expected that all active institutions in the FX market will demand that they have full transparency and access to the same prices as the rest of the market. The drive for increased market efficiencies is expected to result in the majority of the market using eFX venues to trade and the FX market is expected to move forward from \$2.3 trillion per day in 2007 to over \$3.5 trillion by 2010 (ClentKnowledge 2007). ▲

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