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Development in the Foreign Exchange (FX) markets

Overview Forex Industry - comment on the latest BIS report

Last week of September, the BIS (Bank for International Settlements) published their report on the development of the international Foreign Exchange Markets. Every three years statistics from central banks and monetary authorities are put together to watch the development in the world largest unregulated market.

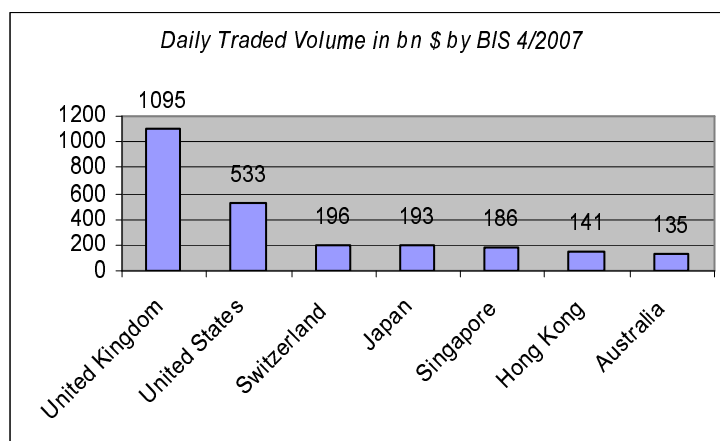
The reviewed data comprise the traditional Foreign Exchange business: FX-Spot, Outright Forwards, Foreign Exchange Swaps and reports the OTC-Derivatives in a separate statistic. In short, the daily traded FX volume increased from \$ 1.880 billion (April 2004) to \$ 3.210 billion in April 2007 – an increase of 71% in three years! This increase was much stronger than the previous one between 2001 and 2004.

The FX industry is at further expansion. Over the past years BIS has resumed low volatility and risk aversion in the markets. The following factors most probably have accounted for this development:

- expansion in the activity of investor groups (including hedge funds);
- expansion of retail investors;
- a trend for institutional investors with a longer-term investment horizon;
- “technical trading” (in particular “algorithmic trading”).

Growth was reported across the entire all instruments but it was particularly impressive in the FX swap market.

The U.K. (34,1% market share) and the U.S. (16,6% market share) are still the worlds largest Foreign Exchange Markets. The U.S. market share has fallen by 2,6%. The market share of United Kingdom has grown 2,8 percentage whilst the Swiss market share has grown 3,3% to 6,1% in total. Japan now handles 6% and is down from 8,3%. Singapore is the fifth largest FX center with a market share of 5,8%. Of interest is the development in India. It has now reached 0,9% of the daily worlds turnover market share and covers some \$ 34 billion by 4/2007 a day (\$ 7 billion in 4/2004).



The currency distribution in average turnover of foreign exchange market ranks first the US dollar with some 42%, followed by the Euro (19%), the Japanese yen (9%) and the Pound sterling (7,5%). Over the last six years the US dollar has lost marginal and the Japanese yen stronger on market share. The portion of the Euro and the Pound sterling has remained stable. Winners were the Australian and New Zealand dollar and Emerging countries (e.g. Chinese Renminbi).

The growth in the OTC derivatives market (cross-currency swaps and foreign exchange options) is not included in above figures. It is separately measured and records an increase of 111% to 300 billion a day (4/2007).

The role of ACI The Financial Markets Association (former FOREX Club)

ACI is a non-commercial organisation with some 13,000 international members at 63 membership countries and individual members in another 15 countries. It was founded in France in 1955 following an agreement between foreign exchange dealers in Paris and London. In the years that followed, other national associations were formed.

The largely unregulated FX market called for a common guideline for our traders all over the world - a guideline focussing on market behaviour, ethic and moral ties in that global booming market. In 1975 the first *ACI Code of Conduct* was published, covering the foreign exchange and euro-currency dealing. In the year 2000 *The Model Code* has been expanded in response to an urgent international need amongst dealers and brokers operating in the OTC foreign exchange, money and derivatives market.

The Model Code is designed to have global application in the OTC professional financial products market. It should be taken as a globally accepted minimum standard for market participants. The adherence by the members (and non-members alike) to the principles set out in *The Model Code* is expected to help keep the professional financial markets free from or subject only to a minimum regulation. The expectation by the regulators and central banks that the market professionals will, at a minimum, adhere to the principles laid down by this voluntary code forms the basis of such a regulation-free trading environment. ACI, through its executives, is in continuous contact with the regulators, and through the Board of Education and Committee for Professionalism, it will continue to promote *The Model Code* and adherence thereto.

But ACI further plays a significant role in the daily business of the financial markets. Topics like "know your customer", "net-working", "electronic trading", "emerging markets", "education" and others are contributing to the markets and their participants. For many years ACI has certified especially new market entrants via the *ACI Dealing Certificate*. This is an tailor made accreditation for inexperienced traders learning about market terminology, simple mathematics and demands a qualified pass rate in market behaviour (*The Model Code*). The *ACI Diploma* builds on the Dealing Certificate to ensure candidates have a good practical knowledge of the treasury and the entire financial markets. Besides both mentioned front office orientated exams ACI provides furthermore for the back office industry the so called *ACI Operations Certificate*. A well-trained and efficiently organised Treasury Operations Department is essential to complete every transaction. Therefore this examination has been designed to provide a benchmark for competency in all aspects of the operations and settlement processes.

ACI became a standard for traders and their banks in the financial markets and the whole industry. It is a standard in terms of

- market behaviour;
- best market practice;

- market liquidity provided by the traders;
- giving advice and offer arbitration services on professional disagreements;
- third party certification (ACI Dealing Certificate, ACI Diploma and ACI Operations Certificate);
- individual and company networking.

ACI is aware on the tremendous development of financial institutions and their need of product diversification. Their increased usage of foreign exchange products challenges the financial markets. Let me highlight a few thoughts which impacts we realize.

The impact of the currency markets to institutional investors (e.g. pension funds)

Over the last years Foreign Exchange was discovered as an alternative asset class to bonds and equities for institutional investors. The market depth (see above) is tremendous and provides a greater liquidity than those of securities. Retrospective surveys suspect comparable returns, if not better, than those of bonds and equities.

Pension funds traditionally have kept the bulk of their money in stocks and bonds – having been the markets' biggest investors. Recent years have seen a revolution in how pension funds look at risk. Previously, foreign exchange exposure was often considered unrewarded risk that was typically managed through a “defensive” hedging program. Low bond yields and volatile stocks in the recent years forced investors into new markets. Now, it's to say, this development also reflects the pressure on fund managers to find further creative ways to increase returns.

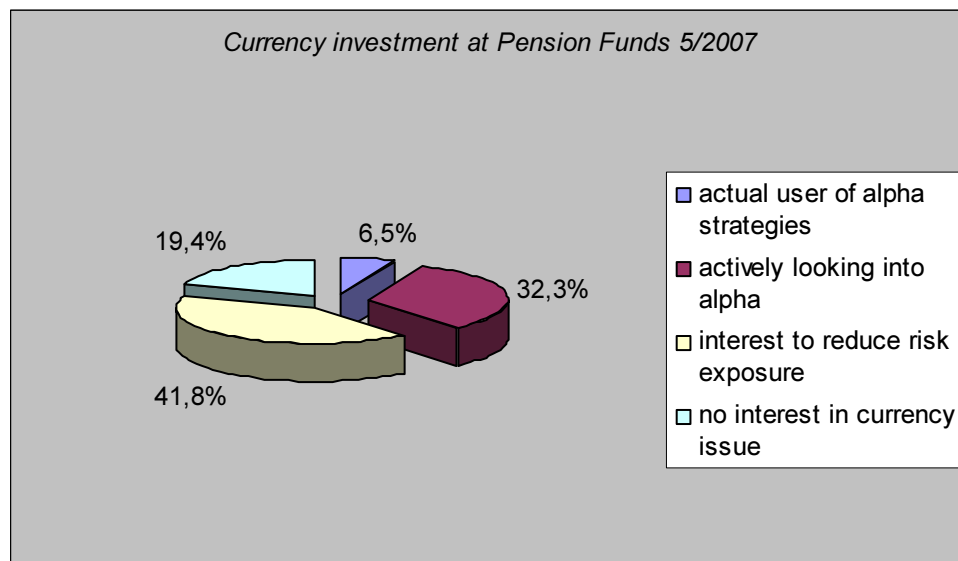
With the intervention of Pension Fund Managers (PFM) in the foreign exchange market their hope has risen for a boost in return. Rough market estimations may recommend FX allocations in the order of 20% - 30% for a global portfolio of Pension Funds. FX provides the flexibility of reducing the duration and magnitude of phases of returns underperformance. That shall help to enhance the quality of returns. Recent developments in the markets show, that FX is not anymore an alternative investment but has become a comparable emphasis.

Given the size and the market power of these investments, PMFs decisions will influence the exchange rate volatility. J.P. Morgan (2002) noted the effect of these institutional investors on the foreign exchange market, to be important, regarding the size of their portfolios. Large shifts of FX portfolios by PMFs might destabilize the foreign exchange markets. One decision by an investor might influence other agent's decision, increasing the impact on the exchange rate and its volatility. Sometimes the power of such investors exceeds that one of the banking industry.

In 2006 foreign exchange was one of the biggest stories in UK local authority pension funds. Considerable investments were reported during the second half of that year. Besides seeking to offset foreign exchange risk a vast majority was looking for active management (alpha). In general and as a part of the overall trend to separate alpha and beta risks, survey evidence also points to increased demand for currency alpha.

Let me stress one interesting survey, but which should be viewed with a critical eye and cannot be considered representative of pension plans in aggregate. But the intuition is, nonetheless, that this paints a fair picture for the UK: A survey of a pension fund audience during the Alternative Investment Forum 2007 (organized by global pensions in May 2007) showed when asked about the treatment of currency within their funds, 6,5% currency invest in alpha generating strategies, 32,3% are actively looking into alpha generating strategies,

41,9% are only interested in reducing risk exposure and 19,4% are not interested in currency issue.



Survey by Global Pensions in May 2007

The Currency Puzzle as investment

Equities have tended to outperform relatively risk-free assets over the long-run. That mirrors the natural expectation of higher equity risks. Contrariwise foreign exchange markets do not only provide interesting volatility on occasion but shows also (some times considerable) interest rate gaps in the currency pairs involved in a transaction. According to the risk-neutral efficient markets hypothesis, the expected gain from holding one currency rather than another should be offset by the loss of interest in holding this currency rather than the other. This implies that “carry trades” would deliver no consistent profits over time. In general a widely consensus has emerged this theory does not confirm the reality. Most strategies that are based on “carry” are likely to be profitable. Nevertheless, the challenge remains to avoid sudden large losses which occur from time to time.

The investment industry may expect further superior growth in pension fund assets under management. Significant assets are so far mainly concentrated in a few developed economies but others arrive and will balloon the volumes. Diversification of investments and pressure on high returns will challenge the foreign exchange markets. ACI The Financial Markets Association will seek for a closer cooperation with this distinguished asset classes. The major goal remains to support our members and the markets and to grant a smooth and harmonized trading environment as much as possible.

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