FX – holding up in the global liquidity crisis

The global financial system has been in a crisis for almost 18 months now. The EUROFI, the European think tank (advising the ECOFIN Council) dedicated to accelerating the integration and efficiency of financial services in Europe recently identified some key causes behind the crisis:

- long period of excess liquidity
- low interest rates for too long
- excessive appetite for poorly measured risks
- misuse of securitization

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Untouched by this global liquidity crisis Foreign Exchange business is doing pretty well – spreads widened and volumes are still moving up. Foreign Exchange has seen an outstanding annual increase of 18% over the past 6 years. The figures are known, and we can assume the daily traded FX volume has already exceeded some US$ 3,500 billion a day by the 4th quarter 2008.

Driving forces in the markets

ACI recently went into discussion with representatives from the industry on the Foreign Exchange phenomenon. It was no surprise the strong increase in this area has been facilitated by electronic trading platforms, algorithmic trading as well as a strong growth from the investment community.

At the beginning of the millennium e-trading platforms were still relatively new and concentrated on building their customer base. In the years that have followed e-trading has become one of the most common ways to trade FX, allowing organisations to access increased efficiencies for sell-side organisations, as e-trading has allowed them to offer FX prices and services to a larger number of participants, helping to enlarge the FX market.

On the other hand algorithmic trading strategies have become an increasingly important part of the growth in FX too. As computer programs have become more sophisticated, being able to use an algorithm to not only identify a suitable trade but complete the trade as well, less reliance has been placed on human beings as less manual intervention has been necessary. The result of this is that the cost of FX trading has been reduced, meaning that even smaller, high frequency trades have become profitable if done by an algorithm. This has led to an explosion in the number of FX trades being dealt and has boosted market liquidity in general. According to BIS in December 2007 they accounted for half of the increase in total FX turnover over the past three years.

We are also identifying a strong growth from the investment community, both real money asset managers and hedge funds, who are investing in currencies as an asset class. The growth is seen on both the relationship trading but also on anonymous trading sides.

Where is this growth being seen?

Strong growth may be seen outside the G10 currency pairs, in particular in the South African rand, Indian rupee and Turkish lira. These currencies are becoming more actively traded and volumes are being driven by carry trade. Also, in the past, exceptional growth has been reported in the Russian rouble, and this was most notable between December 2006 and December 2007, and was predicated by convertability in July 2006.

The current climate has been an interesting test case for e-FX, with volatility driving huge volumes and systems more than standing up to the challenge, proving how stable FX is as an asset class. In this environment the balance has shifted towards relationship-based trading over the past months as participants see the value, and take advantage, of the relationships, credit lines and liquidity that are available. Relationship trading is seen as a valuable way of trading in the market, as prime brokers become less willing to commit credit lines to anonymous venues.

However, demand for anonymous venues remains as institutions look to manage and offset the risk from relationship trading by using multiple venues. This practice is becoming increasingly important for institutions as advances in technology mean they can easily and efficiently connect to multiple venues, and the risk associated with connecting to only one venue has risen. Competition amongst anonymous venues will therefore be on speed, latency, price and efficiency.

Relationship in the FX community

Electronic trading brings many benefits to the whole market, like lower costs, efficient processing and increased price transparency, but there will always be a need for manual trading for perhaps larger sizes or more difficult trades. For these trades relationships between FX traders remain vital. Electronic trading has allowed sales staff to move away from handling plain vanilla trades, towards helping them to develop deeper, high value customer relationships.

Under MiFID, every bank, custodian or asset manager that provides FX as part of an investment service in Europe will be required to implement and document best execution policies. Best practice is a major driver for the adoption of online trading, because using an online trading system can help improve efficiency, transparency and auditability. It can facilitate compliance with governance, reporting and accounting regulations, such as Sarabanes Oxley and IAS 39. It can also make it easier to achieve and prove best execution.

Industry associations such as ACI, which acts as a talking shop for traders who meet less frequently, also play an increasingly important role as forum for discussion and events such as the ACI's World Congress are beneficial as an opportunity to speak with many participants from various geographical locations in one place, to discuss the important issues affecting the FX market.