Foreign Exchange Contact Group

The future of the e-Forex

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The future of the e-Forex

From the phone-based FX to the e-Forex : main features and short term issues.
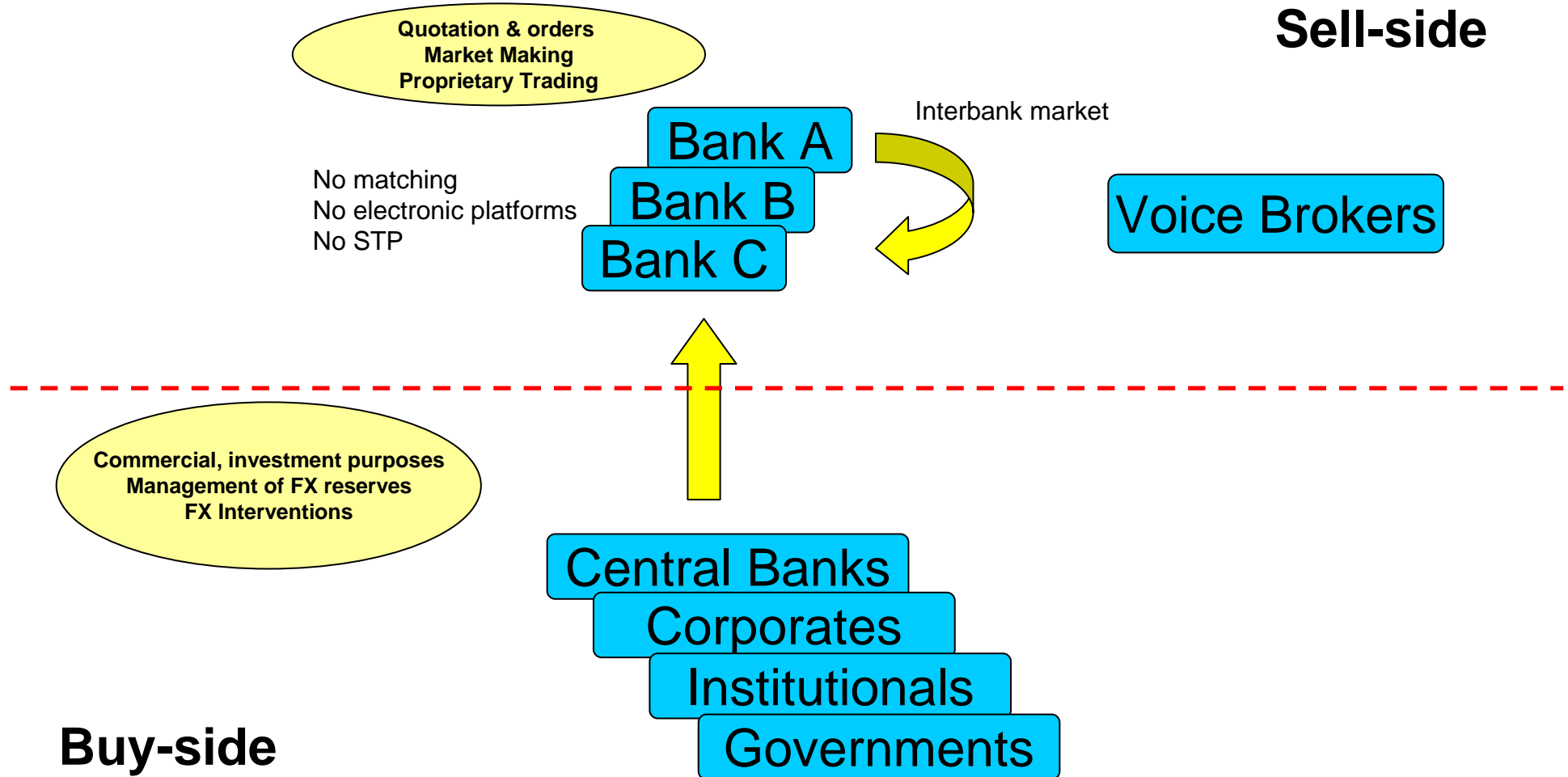
Last key e-Forex statistics.

The booming Retail Market.

Algorithmic trading : comparison with the equity market, Systematic Liquidity Management and impacts on liquidity.
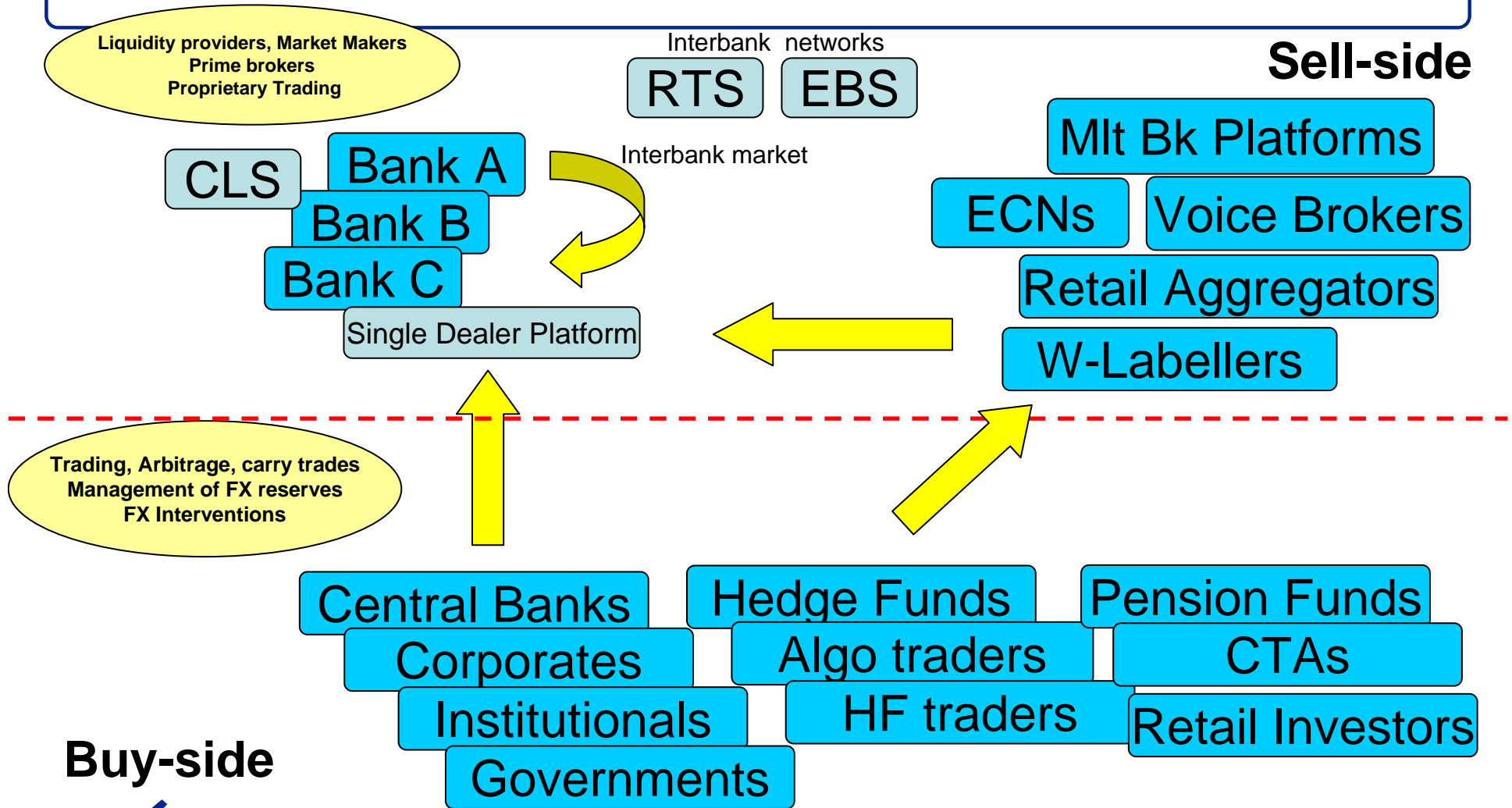
Conclusions.

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The phone-based FX market

Sell-side

Quotation & orders
Market Making
Proprietary Trading

Interbank market

Bank A
Bank B
Bank C

No matching
No electronic platforms
No STP

Voice Brokers

Commercial, investment purposes
Management of FX reserves
FX Interventions

Central Banks
Corporates
Institutionals
Governments

Buy-side

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The e-Forex market

Liquidity providers, Market Makers
Prime brokers
Proprietary Trading

Interbank networks

Sell-side

RTS   EBS

Interbank market

CLS   Bank A

Bank B

Bank C

Single Dealer Platform

Mlt Bk Platforms

ECNs   Voice Brokers

Retail Aggregators

W-Labellers

Trading, Arbitrage, carry trades
Management of FX reserves
FX Interventions

Central Banks   Hedge Funds   Pension Funds

Corporates   Algo traders   CTAs

Institutionals   HF traders   Retail Investors

Buy-side

Governments

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The e-Forex : main features

- Great diversity of market participants, new business models, new market segments.

- Traditional relationship model → anonymous model → more challenging for the banks to act as market makers and warehouse the risks.

- Turnaround in the traditional FX business model of banks :
    - Low volumes – high margins → high volumes – low margins
    - Proprietary trading → efficient management of high volumes.

- Transaction costs are reduced → new strategies → additional volumes.

- FX is an asset class on its own → additional volumes.

- Emergence of a fast/high-frequency trading environment.

FX Average Daily Turnover ($ bios)
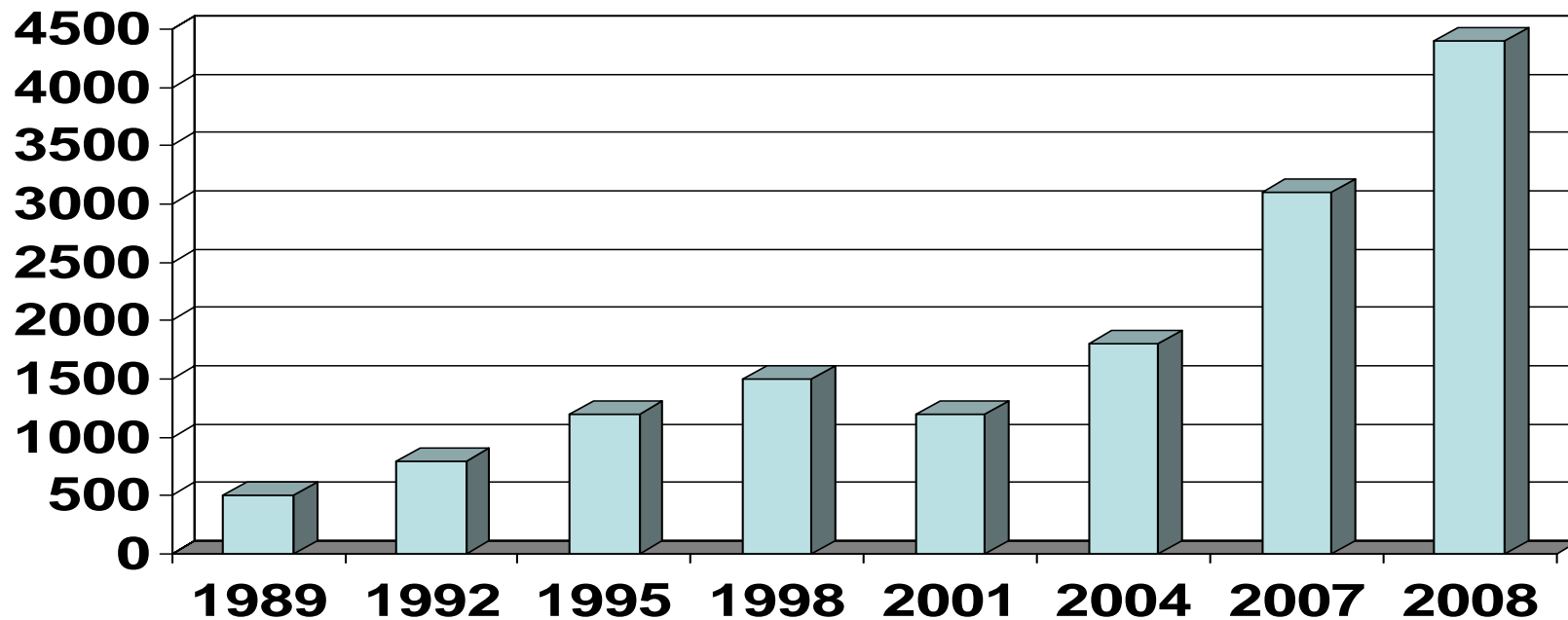
Sources : BIS, Aite Group estimates

The e-Forex : short term issues

Latency :

- Low latency is a core requirement.
- Risks and costs are difficult to evaluate.
- We must reduce it through a continuous improvement process.
- Focus is often on network latency not on application latency.
- Solutions : proximity with the execution venues, efficiency of the application, sufficient bandwidth, etc.

Connectivity :

- FX participants need an immediate and fast access to the **whole** electronic market, algorithms need to work across multiple pools of liquidity.
- Lack of standardization but it becomes easier to connect to various execution venues with the increased adoption of the FIX protocol and APIs.

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The e-Forex : short term issues

FX market data :

- Algorithmic trading requires reliable market data.
- Unfortunately FX is a fragmented market.
- But standardization of market data is improving (FIX/FAST protocol).

Post-trade processing costs :

- e-Forex fuelled a rapid growth of daily tickets traded and processing costs are now an issue.
- FX processing costs are very depending on the size of the players.
- Post-trade FX market still inefficient for many reasons.
- CLS and ICAP just created a joint venture to address pre and post-trade processing issues.

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The e-Forex : key statistics

- Global FX trading volumes grew 15 % year-over-year in 2008.

- e-Forex trading volumes grew 37 % mainly driven by Retail Aggregators (+ 43 %) and Corporate FX Traders (+ 26 %), HF activity retreated (- 28 %).

- For the first time the e-Forex takes the lead.

2007

2008

e-FX, 44%

Other, 66%

Other, 47%

e-FX, 53%
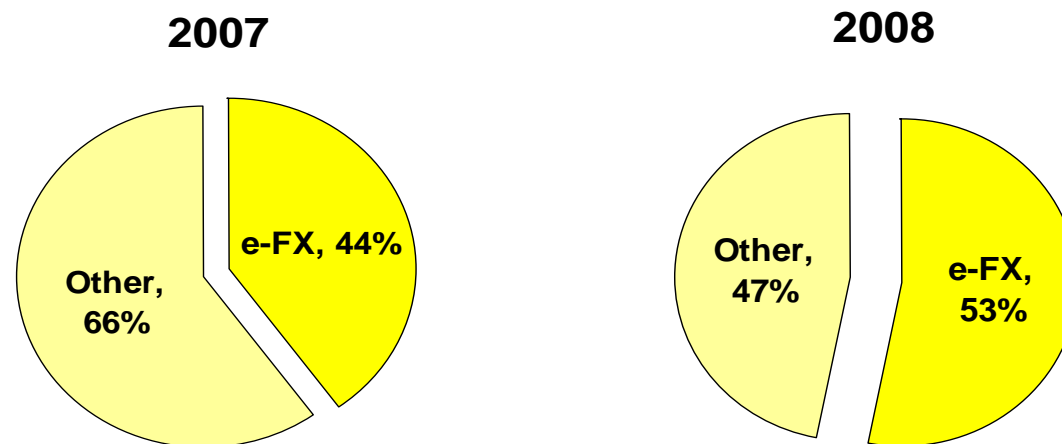
Share of Global FX volumes executed through electronic systems

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The e-Forex : key statistics

- Modest inflow of new e-FX customers, usage rate has been stable year-over-year (57 % in 2008 from 55 % in 2007).

- Some regions and market segments are still under 50 %.

Percent of FX Traders using Electronic Trading

Legend: ■ 2007 ■ 2008

Categories: Global, US, Europe, UK, Japan, Asia (exc Japan), Canada

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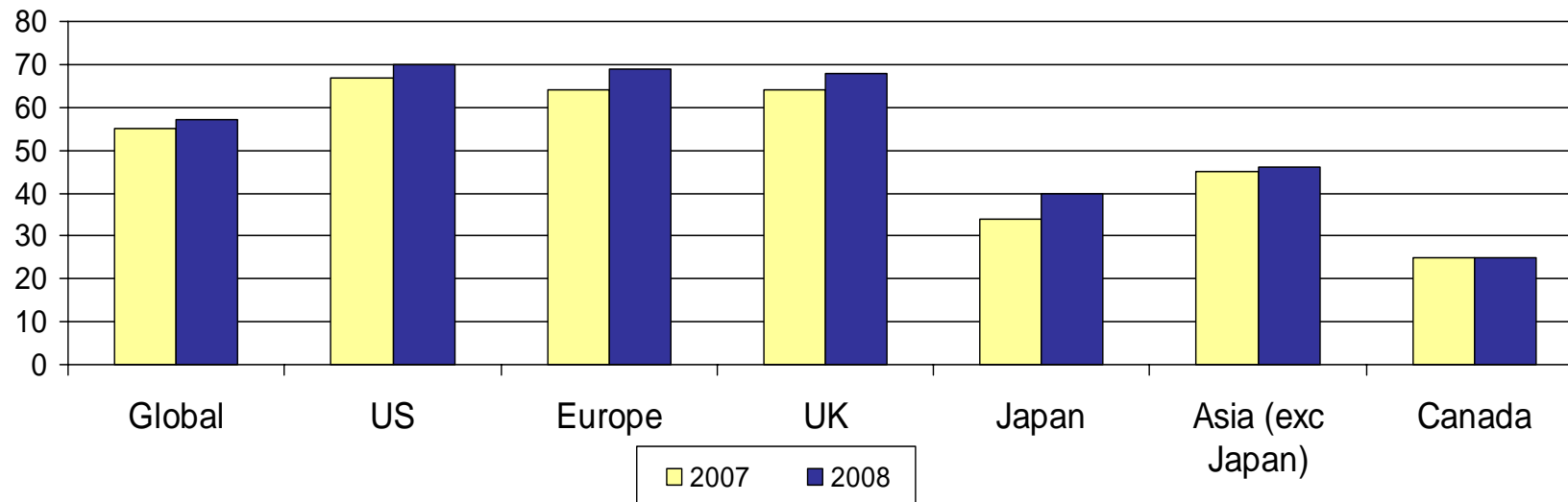
The e-Forex : key statistics

Proportion of FX Trading Volume by Execution Channel among online Traders
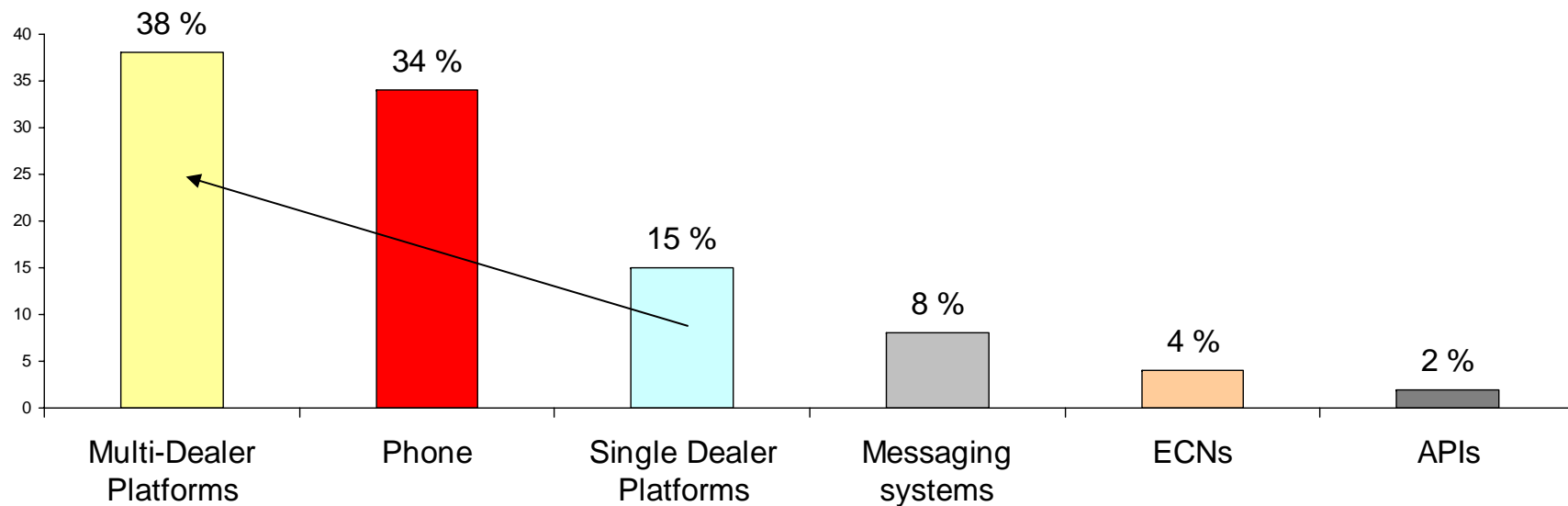
- 34 % still done by phone
- Clear shift from single-bank to multi-dealer systems mainly from corporates and institutional traders.
- Banks are the sole exception : 75 % use single-bank systems.

The e-Forex : booming Retail Market

- The Retail FX is the booming segment nowadays.

- Banks entered this field lately :

  - Retail market was outside of their traditional coverage models.
  - How can banks really differentiate their offerings now ?
  - Banks have also strengths (brand name, rating, access to liquidity, regulation).
  - White labeling has also lowered the access barriers.

- Stronger competition ahead.

- Regulators have a great challenge in this particular segment.

- Client burn-out rate could be a medium term issue.

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The e-Forex : algorithmic trading

- 40 % of the orders in EBS come from algorithms.

- Trading algorithms : used to generate a trading signal.

- Execution algorithms : once the trading signal has been generated the execution algorithms manage the order.

- Till now the focus has been on the development of trading algorithms.

- The development of execution algorithms is still at the early stages, there is some scepticism about their potential.

- The development of more sophisticated algorithms is still in a nascent stage.

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The e-Forex : comparison with the equity market

- The adoption of Algorithms in the equity market started earlier, less sophistication and more limited choice of FX Algorithms.

- FX market is fragmented, no centrally reported data available.

- Prices are not quoted the same way in the two markets : risk price Vs market risk.

- Banks with FX trading desks might face conflicts of interest and mistrust when delivering Algorithms to the buy-side.

- Will the success story of the equity market repeat here ?

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The e-Forex : Systematic Liquidity Management

• Banks have no choice than to automate further, they will deploy FX algorithms for systematic liquidity management.

• Algorithms are used to manage liquidity and to automate the whole FX trading process : auto-pricing and auto-risk hedging.

• Results :

  • Improved efficiency of the whole trading process.
  • Increased pricing capabilities.
  • Improved risk management.
  • Improved capabilities to drive the FX business thanks to trade data analysis.

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The e-Forex : impacts on liquidity

- EBS and Reuters are still the main references for the pricing engines.

- e-Forex increases the liquidity but this can be « short lived » and « over exaggerated ».

- What can be the impact on liquidity of anonymous trading and the use of execution algorithms ?

- Volatility could increase at any given time if most trading algorithms use more or less the same model in the future.

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The e-Forex : conclusions

- The e-Forex should stay an OTC market with leading platforms.

- Automation will increase further and human traders will be replaced by algorithms and model developers.

- Required IT investments will remain at high level, next step is multi-asset class platforms and algorithms.

- The modest inflow of new e-Forex customers year-over-year suggests that the market penetration is already at high levels and that the market becomes mature.

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The e-Forex : references

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- Algorithmic FX Trading : Development, access and deployment : Lessons from the first wave of Algorithmic FX execution, e-Forex Magazine, January 2009.

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