



FX Market

Addressing the real issues

*CESR Consultation : non-equity markets
transparency*

June 4, 2010

The FX market

Not a “derivatives” market

- **Exchange of currencies: a basic mechanism fundamental to the global financial system**
- **Largest financial market by volume (ca. USD 3.2 trillion daily)**
- **Vast number of participants compared to most “derivatives” markets**
- **Individual needs of participants as diverse as the participants themselves and the individual cashflows each needs to manage**
- **86% of FX transactions involve the US dollar as one leg (although trend is declining)**
- **Very short dated market; 81% of FX market volume is for 7 days or less**
 - 30%: FX Spot: Exchange of currencies in 2 days
 - 11%: FX Forward: Exchange of currencies any day from today (43% of fwds under 7 days)
 - 51% FX Swap: a combination of a Spot and a Forward (78% of swaps under 7 days)
 - 6% OTC FX Option: exchange of currencies on given day only if certain conditions met
 - 2% Exchange traded FX futures and options (c. 95% futures)

Includes “Non-deliverable” Forwards, Swaps, Options (common in some emerging markets)

NB: Cross-currency swaps are typically considered interest rate products, NOT FX.

Counterparty Risk in FX

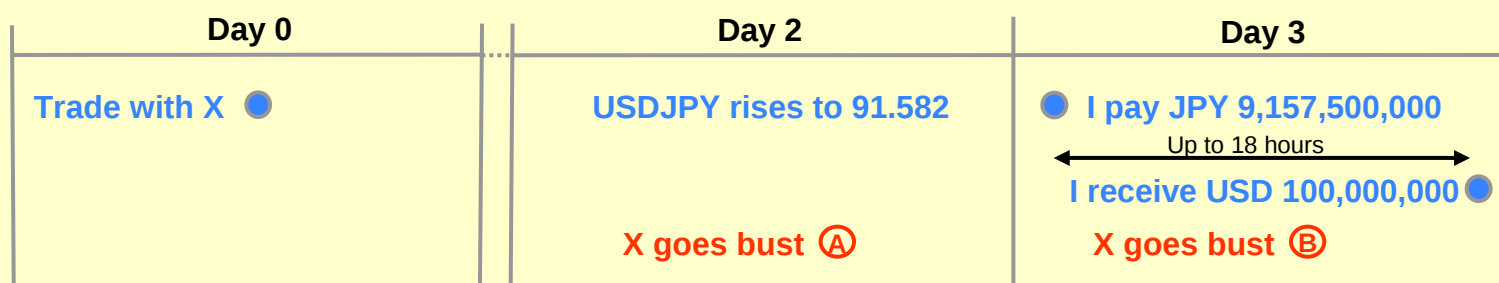
FX counterparty settlement risk dwarfs counterparty credit risk in a typical FX trade

FX Counterparty Settlement versus Credit risk: Example

I buy \$100m USDJPY 3 day FX forward at 91.575 from Counterparty X

This means I have contracted, in 3 day's time, to:

- pay to Counterparty X JPY 9,157,500,000
- receive from Counterparty X USD 100,000,000

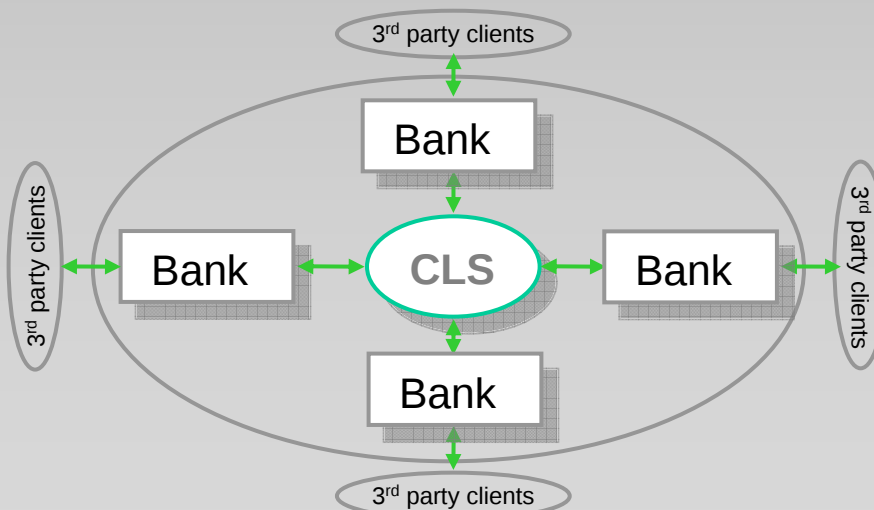


- **If X goes bust at point (A), I lose c. \$7,600 due to Credit risk loss**
 - No money has changed hands
 - To receive the \$100m I need on Day 3, I now have to buy them at 91.582 from another counterparty
 - My Credit Risk Loss is the additional JPY 700,000 (= \$7,643) I now need to pay for the dollars (if rate moved other way, this would be a gain)
- **If X goes bust at point (B), I lose c. \$100 million due to Settlement risk loss**
 - I have paid the full JPY 9,157,500,000 but I will not get the USD 100,000,000 in return
 - If I still need to buy the dollars, it will also cost me the additional \$7,643 as above (assuming rate is still 91.582)
 - In practice, this may well trigger my own bankruptcy, which will have a knock on effect to my other counterparties (risk of systemic collapse)

Mitigation FX settlement risk

CLS Bank and other mechanisms mitigate FX Settlement Risk (but only if people use them)

- CLS Bank is central settlement system launched in 2002 to mitigate FX settlement risk (supported by all major central banks)
- CLS provides a payment-versus-payment system (PvP) that guarantees no loss of principal upon counterparty default
- CLS now covers c. 55% of all FX settlements (c. 95% of interbank settlements)
- Other mechanisms (e.g. internal account settlement) mitigate settlement risk from further estimated 20% of FX settlements
- This still leaves c. 25% of FX settlement risk in the global financial system
- NB: There is no obligation or regulation that requires FX market participants to reduce Settlement Risk



Why imposing CCPs would be wrong for the FX market

It tackles the wrong problem, and makes tackling the right problem harder

Remaining FX Settlement Risk is still one of the most important systemic risks in the global financial system

Many 1000s of FX market participants (mostly smaller market players) still incur FX settlement risk every day

Most common excuse for not using CLS or another mechanism is that they are “too expensive” / “not worth the investment”

CCPs address Credit Risk not Settlement Risk, which is much more relevant in other asset classes

Unlike FX, many OTC derivatives do not involve an exchange of principal (i.e. no Settlement Risk)

Credit risk rises with duration; the credit risk of a 3 month FX forward is tiny compared to a 30 year interest rate swap

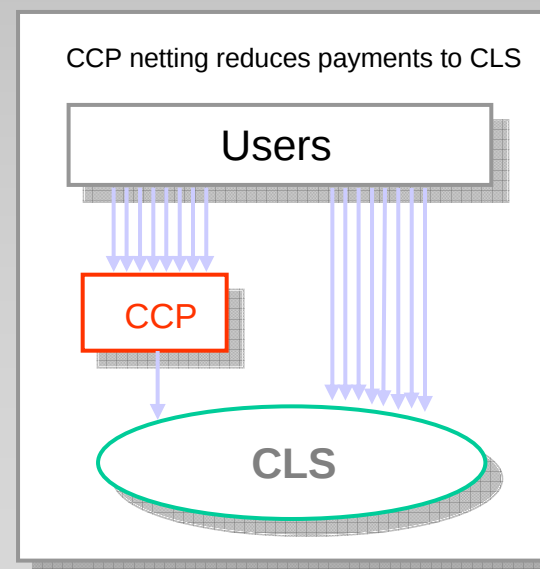
Imposing CCPs on FX will make it even harder to persuade more people to use CLS

CCPs net settlements down to single net daily payments, which means fewer payments into CLS, therefore cost per settlement in CLS will rise proportionally, further discouraging uptake by smaller users.

Similarly, forcing people to incur integration costs with CCPs will make it even less likely they will additionally integrate with CLS

Imposing CCPs upon FX will therefore:

- Impact many 1000s more participants than those involved in true “OTC derivatives”...
- most of whom are simply managing currencies and cashflows involving trades of a few days or weeks, that bear relatively little credit risk...
- thereby imposing a large cost burden for negligible benefit in terms of systemic risk mitigation...
- and making it even harder to address the real systemic issue of FX Settlement Risk, which is where regulators and industry should be placing their focus.



FX market transparency

FX market has a highly sophisticated and transparent dealing infrastructure

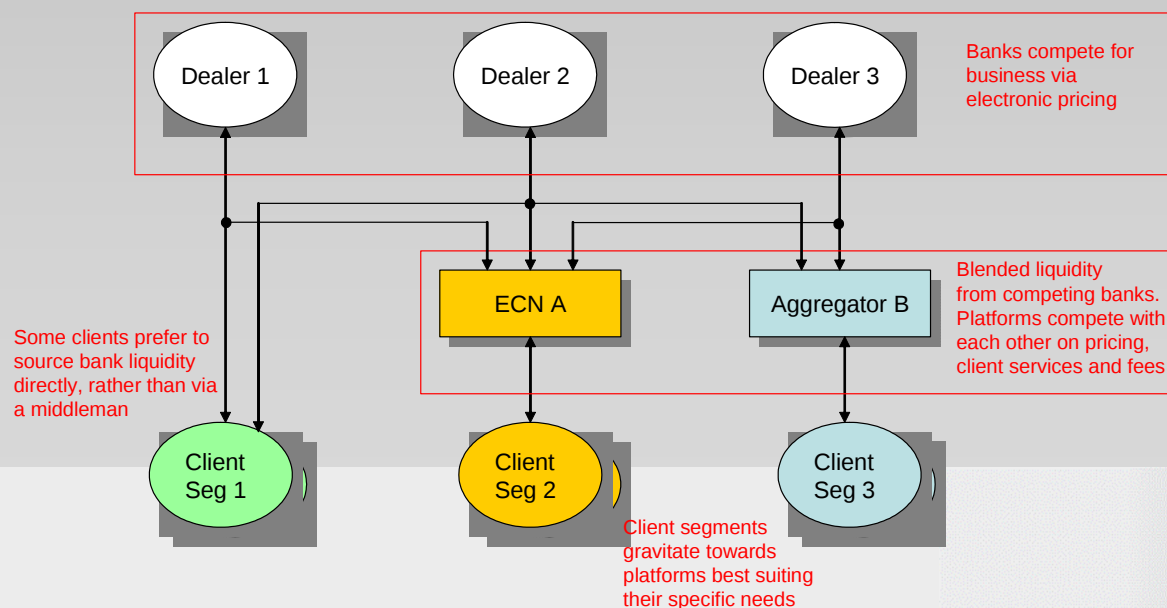
FX market was an early pioneer of electronic trading

Banks compete by distributing live executable prices in spot, forwards and options

- Live streaming prices in Spot and common Forwards; large number of gridpoints / pricing parameters require Options and other Forwards to be priced electronically on a Request-for-Quote (RFQ) basis

Clients may access prices in several ways:

- Via an ECN “agent” that combines the best competing prices from many sources
- Via an aggregator that often acts as a principal, combining best prices and may even improve upon the best bank price
- Direct with banks and market makers, often when the user wants the much richer functionality available compared to that which is available on general platforms



Clients can get better prices than banks

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 **0.9 EUR/USD spread**

OANDA offers the same low spreads to all traders, regardless of account or trade size. Current spreads are shown live, visible to all.

Realtime Forex Rates

FXTrade	Dealable Rates	Spread
EUR/USD	1.43541 / 50	0.9
AUD/USD	0.91561 / 78	1.7
EUR/CHF	1.48267 / 84	1.7
EUR/JPY	132.379 / 403	2.4
GBP/USD	1.59771 / 90	1.9
GBP/JPY	147.348 / 83	3.5
NZD/USD	0.73297 / 318	2.1
USD/CAD	1.03559 / 78	1.9
USD/CHF	1.03284 / 301	1.7
USD/JPY	92.226 / 35	0.9
XAG/USD	18.00900 / 3300	240.0
XAU/USD	1130.470 / 800	33.0

☐ Market Event [See All Spreads](#)

EUR/USD 5min © OANDA Corporation

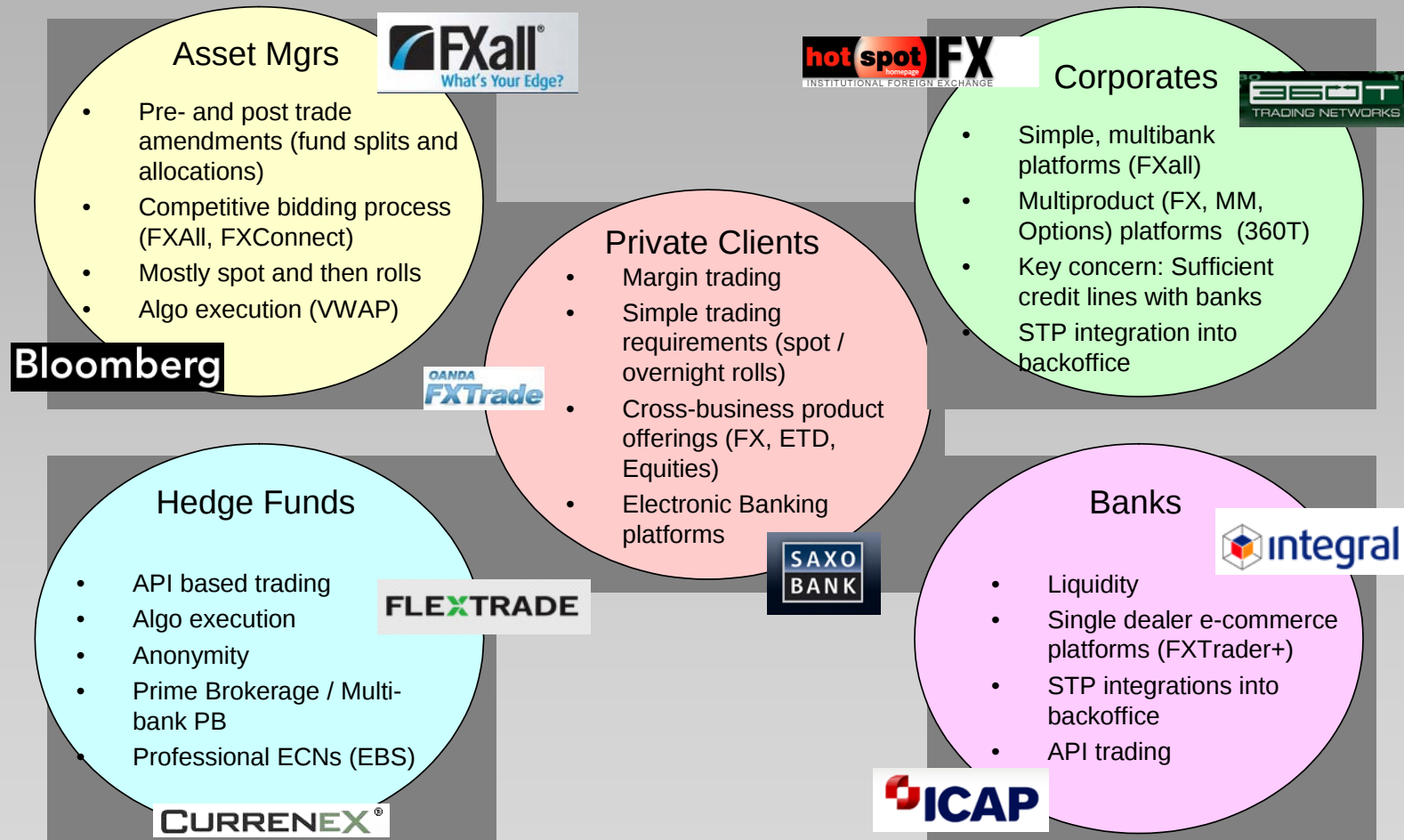
Example: on this widely available platform, EUR/USD spot is 0.9 pips wide ($\approx 0.006\%$)

In the interbank market it is typically 1-2 pips wide

Pricing to end clients is extremely competitive and transparent

A large number of platforms compete to Service FX market users

Different types of users have very specific needs that some platforms cater for much better than others



Central reporting, not “exchange trading”

Any need to enhance FX market transparency should be met by a central repository. Exchange trading makes no sense for FX.

Overall end-user experience would almost certainly be worse if all dealing forced onto one or two venues

Dealer pricing would change little (already extremely competitive)

Client pricing and service would almost certainly suffer as venues would not have to compete so intensely for client business

Classic exchange trading would not work for main FX market

Cannot reduce market down to a few standard gridpoints; the cashflows people need to manage are infinitely variable

Exchange trading (incl. CCP) has been available in FX for many years but has only ever gained 2-3% of market share even during the credit crisis

FX market is building a central repository in response to regulatory demand

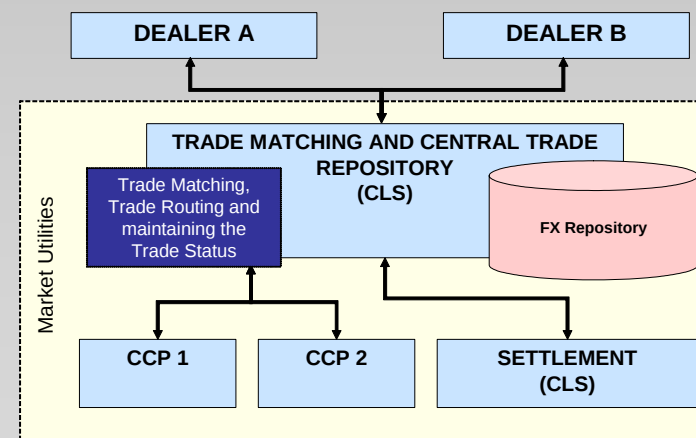
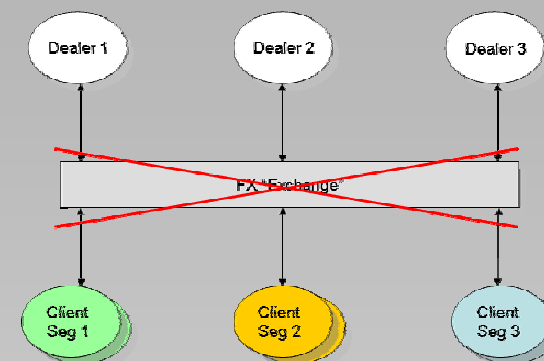
Extending existing CLS repository, which was used by regulators during recent crisis

Will provide unprecedented regulatory transparency

FX market public transparency could be further enhanced by publishing post trade data

Precise reporting rules would need careful design to promote transparency without damaging liquidity

NB: Will need agreement of central banks



Summary: This is too important to get wrong

Sweeping up FX in general “OTC derivative” legislation will harm a systemically important market

Exchanging currencies via the FX market is fundamental to the world's financial system

FX is very different in many respects from “OTC derivatives”; what may work for one will NOT work for the other

Far greater number and diversity of participants

Very short term market; credit risks are relatively negligible, but FX settlement risk is systemically important to the entire financial system

Mandating CCPs will bring negligible benefit and will hamper tackling the real task: further reducing FX settlement risk

FX market is already highly efficient and transparent

End users can often achieve better prices than available in the interbank market

Requiring reporting to central repository will provide full regulatory transparency

How much to make public needs to be agreed later, especially with world's central banks

Mandating classic “exchange trading” makes no sense for FX

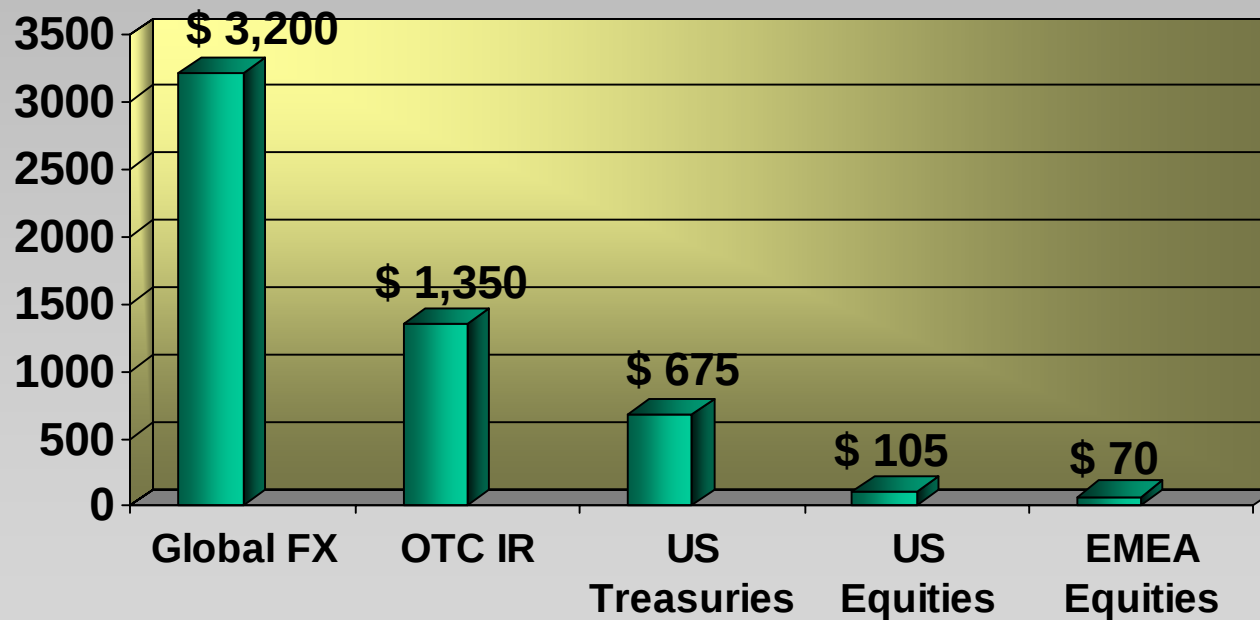
Users' individual FX needs are as diverse as the individual cashflows that each needs to manage

New legislation should:

- NOT mandate CCPs for FX
- NOT mandate exchange trading for FX
- REQUIRE central reporting
- REGULATE overall FX market under those body/bodies tasked with regulating overall systemic risk
 - Facilitate subsequent drive to further mitigate FX settlement risk

Annex 1: Daily product turnover

Average Daily Turnover 2007 / in USD Billions



Source of statistics: Bank for International Settlements, Triennial FX Market Survey 2007

Annex 2: Global FX market turnover

Daily averages in April in billions of US dollars

	1992	1995	1998	2001	2004	2007	Change 2004/2007
Spot transactions	394	494	568	387	621	1,005	+62%
Outright forwards	58	97	128	131	208	362	+74%
FX Swaps	324	546	734	656	944	1,714	+82%
Estimated gaps	43	53	61	26	107	128	+20%
TOTAL	820	1,190	1,490	1,200	1,880	3,210	+71%

The largest FX-Financial Centres ... represent 68,6% of the overall volume in 4/2007

	Volume	Market share	+/- vs 2004
UK	\$ 1.095 bn	34,1%	+2,8%
US	\$ 533 bn	16,6%	-2,6%
CH	\$ 196 bn	6,1%	+3,3%
JP	\$ 193 bn	6,0%	-2,3%
Singapore	\$ 186 bn	5,8%	+0,6%

Annex 2a: The growth of the FX markets

Increase by more than 70% over the three years to April 2007

Growth in transactions between banks and other financial institutions (consistent with the increasing importance of hedge funds, as well as portfolio diversification by institutional investors with a long-term horizon, such as pension funds)

There has been a marked increase in turnover involving emerging market currencies

The growth was broadly based across traditional foreign exchange instruments, the pickup in the growth of foreign exchange swaps was particularly strong (increasing to 82% from 44% over the previous three years)

Trends in the growth of turnover by different types of counterparty established in early surveys have continued

- | | |
|--|-----------------|
| -increase between reporting dealers (commercial banks) and IB, FI, Hedge/Pension Funds | from 33% to 40% |
| -share between reporting dealers and non-financial customers rose | from 14% to 17% |
| -the share of interbank trading continued to fall | from 53% to 43% |

Small but significant changes in the currency composition of foreign exchange turnover

In particular, the presence of emerging markets has increased

This potentially points to significant longer-term trends and may have implications for the geographical distribution of foreign exchange sales

Summary: It looks like the growth were based by leveraged investors exploiting short-term profit opportunities through strategies such as the carry trade, and by investors with a longer-term horizon were diversifying their portfolios as well as by the strong presence of algorithmic traders

Annex 2b: The growth of the FX markets

Rapid growth in turnover with financial customers

Financial customers were the main drivers of the strong rise in global turnover

Growth in this segment has accounted for half of the increase in total turnover over the past three years, compared with 29% for interbank trading and 21% for the non-financial customer segment

- Leveraged investors discovered FX and attracted by good returns within relatively short time
- Investors with a longer-term investment horizon have been actively diversifying their portfolios
- Increase of high-frequency algorithmic trading by some investors (mostly investment banks) has also increased turnover, particularly in the spot market

Market commentary has suggested that **leveraged investors such as hedge funds have been primary players** in foreign exchange market activity in recent years.

- Leveraged retail investors appeared to be a growing presence in foreign exchange markets
- Retail investors have had significantly more access to margin accounts through online trading services
- Strategies such as the carry trade (using leverage to exploit interest rate differentials and exchange rate trends in an environment of low financial market volatility), have been profitable over the years 2004 – 2007
- The BIS report identified as carry trade targets, such as the Australian and New Zealand dollars (experiencing strong growth between April 2004 and April 2007)

Hedge fund activity has increased significantly over the years 2001 – 2007 – concentrating in the United States and London

Annex 2c: The growth of the FX markets

The rising importance of emerging market currencies

Emerging market currencies grew significantly faster

Emerging market currencies are estimated to be on **at least one side of almost 20% of all transactions** (compared to less than 15% in April 2004)

The largest growth rates in turnover for emerging market currencies were in transactions between banks and non-financial customers (157%) and financial customers (144%)

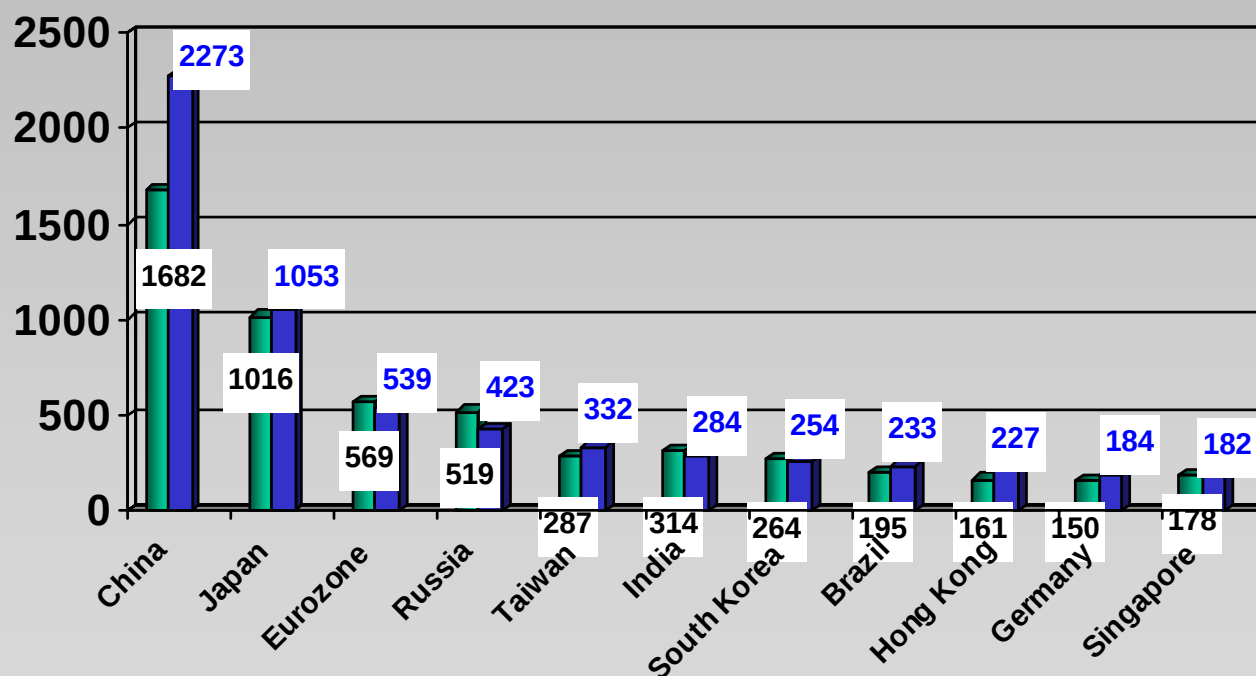
The rise in turnover was **particularly pronounced for the Hong Kong dollar**, and occurred across all three traditional foreign exchange instruments

The most important emerging market currencies are the **Hong Kong dollar**, the **Polish zloty** and the **South African rand**.

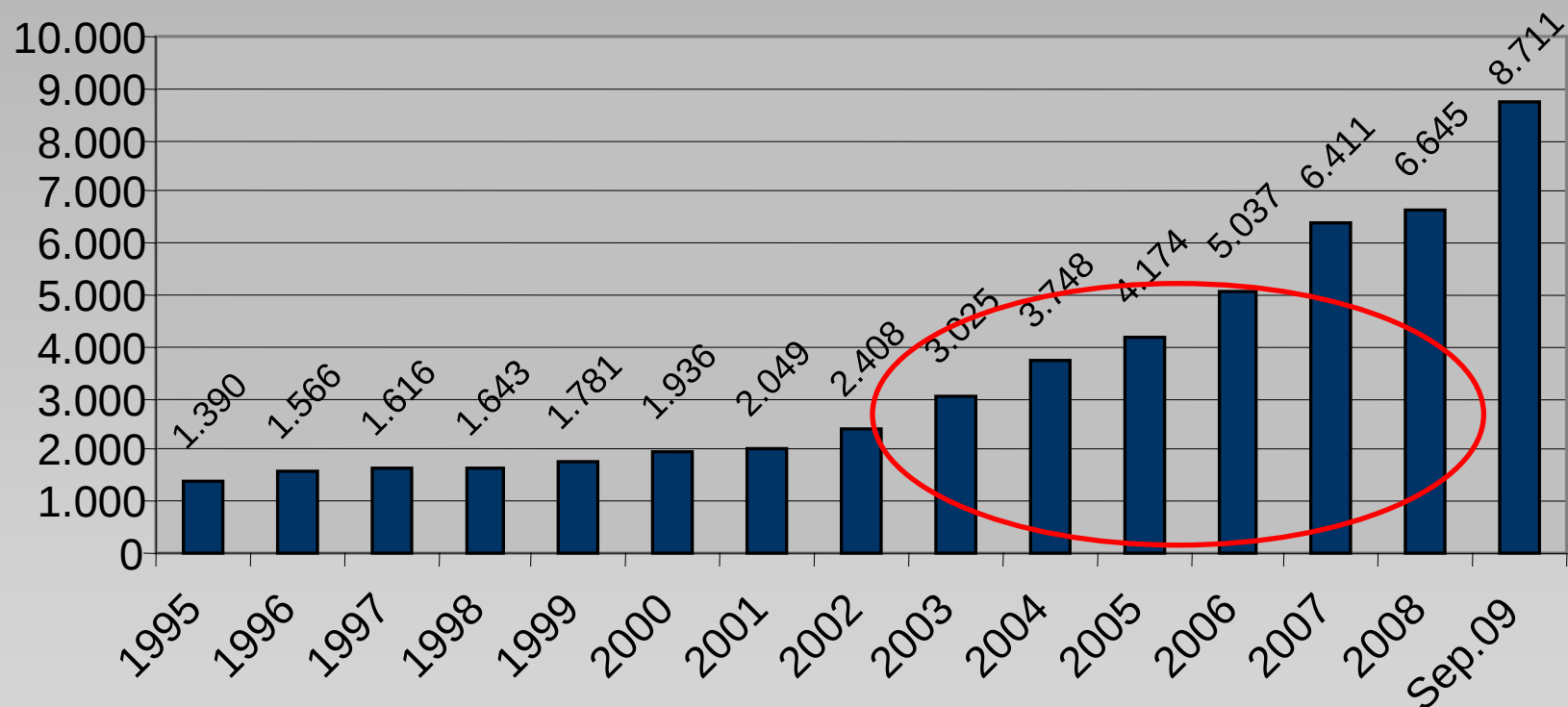
Annex 3: Currency Reserves – China's strength

1995	2000	2004	2007	9/2009
75,4bn	165,6bn	609,9bn	1.528,2bn	2.272,6bn
Development China Currency Reserves in USD			+151% vs ,04	+49% vs 2007

In Billion USD – 3/2008 vs 9/2009



Annex 4: Currency Reserves – global development





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