Insideview

Foreign Exchange Markets and Electronic Trading

INTERVIEW WITH CARLO KÖLZER, 360 TREASURY SYSTEMS

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Please provide a brief overview on the status quo of trading in foreign exchange (FX) markets. In which way was it affected by the financial crisis?

The FX market is in very good condition. Even at the peak of the crisis when credit lines amongst banks were very limited to non-existing, the FX market still worked. There was less liquidity and the spreads were much wider, but participants could always get out of their positions. This was and still is a major difference to other markets like credit derivatives or bonds.

Today, we have another phenomenon. Given the fact that the problems of banks and other parts of the industry have been transferred into the public sector, there is high pressure on interest rates and exchange rates, like Greece weakening the Euro. This leads to high volatility and activity.

Did technology broaden the range of market participants that want to directly participate in FX markets?

Indeed, over the last ten years major new categories of participants have entered into the FX market. Enhanced technologies and e-commerce are in fact the main enablers for that development. Between 1998 and today, the overall FX market has grown from USD 2 trillion in daily trading volume to USD 4 trillion. This growth was only possible through the scalability of electronic trading.

The new strong group of participants are institutional players. And here we have three subsets. There are the asset managers that trade much more FX than they used to. They strip the FX risk from the underlying security risk (e.g. bonds), and manage it separately. They introduced overlay management on FX and they identified FX as a separate asset class. A second category that has been boosted by electronic offerings is the retail market. Ever more individuals invest and speculate in FX. Thirdly, hedge funds had tremendous momentum in the last couple of years and traded a lot of FX on either a macro level, on a latency arbitrage basis or just as hedges for carry trades from credit facilities in foreign currencies like the Japanese Yen.

The access to aggregated liquidity through electronic trading venues has highly catalyzed the FX market.

What drives the transformation of the FX market from phone-based over-the-counter trading to a market dominated by rule-based electronic trading?

The FX market was a very fragmented M-to-N market, where participants called some banks to find out the best price. Transparency did not really exist and the search costs were high. Automation did not exist; neither did a proper audit trail on an automated basis.

The key advantages of electronic trading are transparency, straight-through processing, audit trail documentation, and performance measurement as well as an overall reduction of costs.

Rule-based trading is not as matured in the FX market as it is in the equity market. The proportion lies at 15 to 20%, but is expected to increase.

What are the key challenges your organization and its competitors are facing due to increased sub-millisecond trading?

Some challenges might occur in conjunction with regulatory changes. Challenges always exist in relation to technological progress and dynamic customer's demand. 360T has to be flexible enough to react on these different dimensions of changes. Proprietary trading might become less, hedges might be more relevant. New currencies might come into the game like the Chinese Renminbi (CNY), the Indian Rupee (INR), the Brazilian Real (BRL), etc. We are forced to invest into an ever faster, more reliable and richer technology... that's the name of the game. So far, we have been very successful in that. Given that we will be celebrating our 10th anniversary this year, we hope to continue to write that success story further.

Thank you for this interesting conversation.