The global FX industry: coping with consolidation

Christopher Swann
The Centre for the Study of Financial Innovation is a non-profit think-tank, established in 1993 to look at future developments in the international financial field - particularly from the point of view of practitioners. Its US affiliate, the New York CSFI, was set up in 2002. The goals of both institutions include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open and efficient markets.

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Unless otherwise stated, CSFI publications can be purchased through Central Books.  
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Printed in the United Kingdom by Heron, Dawson & Sawyer.

ISBN 0-9545208-0-7  
Cover image: Getty Images
Preface

Over the past twelve months, it has been heartening to attend conferences packed with fund managers discussing the opportunities presented by FX, and to visit dealing rooms reporting healthy business. At Reuters, serving the foreign exchange market is at the core of our business and we continuously look for new ways to serve this market better. For many years FX had been a Cinderella business, and it has been gratifying to see the industry taking centre stage over the past year.

Whilst core interbank spot volumes appear to be gradually declining, we do not believe that the significant down-step seen in the years between 1998 and 2001 will be repeated, and indeed our own experience of the past few months shows a lively, buoyant market. But spot FX is only one part of the story: forward FX is a major growth engine, as is the derivative market (although this is more patchy, particularly given recent corporate accidents). Growth opportunities are also being realised in emerging markets, driven by the search for yield described in this paper.

We were pleased to support the writing of this report, and we are delighted with the high quality of insight it offers. Reuters has always been at the forefront of developments in the FX market, and we are committed to retaining this leadership. The FX market is undergoing dramatic change and this excellent report describes the major issues and opportunities with clarity and intelligence. The challenge for all of us is how to harness these opportunities in the most challenging business environment we have seen for many years; for the winners the rewards are immense.

Chris Dunne
Head of Strategy
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The global FX industry: coping with consolidation

Christopher Swann

Foreword

This report has been prepared by the (then) foreign exchange correspondent of the Financial Times, writing in a purely personal capacity. It has benefited from the support of Reuters (which obviously has more than a passing interest in the future of the FX industry), but I must emphasise that editorial control has been entirely with Mr Swann. Reuters staff members have been helpful in suggesting questions for him to look at (and we at the CSFI helped with construction and distribution of the questionnaire which supplemented Mr Swann’s interviews1), but the analysis and conclusions are entirely those of the author – and, I feel bound to say, they do not necessarily make easy reading for Reuters (or indeed for Bloomberg, or any other of the service providers to the FX industry).

What are Mr Swann’s main conclusions?

First and foremost, he believes that the pace of consolidation within the industry is likely to accelerate – with a few banks scooping up business from their smaller rivals. This is a process that has been going on for a while, and (in his view) it is not likely to stop until there are “around ten global FX banks still standing – with another handful sheltering in niche markets”.

One corollary of this is that there will be a lot of “white-labelling” – the big providers boosting the volume of their business by providing FX services to medium and smaller players on an outsourced basis. There may be some reluctance to go this route, but (as one of Mr Swann’s respondents put it) “After all, Calvin Klein doesn’t make his own pants”.

The reason that volume is so important is that spreads are thin and (at least in the spot market) are not going to get much plumper. Plus, the cost of technology is daunting – which means that there is a real incentive to get whatever volume is available from wherever one can. For all but a very few mega-banks, with global branch networks, that means piggy-backing on second-tier institutions.

Of course, given the narrowness of spot spreads (coupled with the increasing sophistication of FX customers and a general feeling that interbank volumes will be under pressure), there will be more emphasis placed on the derivative market – and Mr Swann certainly sees room for optimism here. Clients are more sophisticated, and are more comfortable with more complex FX products – but, once again, there are high barriers to entry in this particular market, and any shift towards derivatives is likely to accelerate the process of consolidation that is the main message of Mr Swann’s report.

Since, as he points out, “volume begets volume”, the future has to look a bit bleak for smaller players. It also poses a challenge to firms like Bloomberg and Reuters. Based on Mr Swann’s interviews, the smaller number of players will tend to emphasise higher value-added products – which means “fewer pure execution traders and a larger number of sales staff and researchers”. Maybe (and maybe a little scepticism is in order here), that will pressure firms to cut back on what they spend for trading terminals – or at least force them to demand greater functionality and/or lower cost.

1 The questionnaire and a breakdown of detailed responses are given as Appendices I and II.
The biggest threat that Mr Swann sees to this scenario may be a bit of a surprise to some – particularly given the implosion of Atriax. The CSFI survey reinforces his belief that, notwithstanding Atriax, the market still sees multi-bank portals as more attractive than single bank portals – a preference that could further undermine the economics of the FX business.

Tough times ahead? Probably, with more and more business (from increasingly sophisticated clients) gravitating to a small group of institutions who have the volume to compensate for wafer-thin spreads and a huge technology/processing spend. That is going to pose an enormous challenge to institutions that are on the cusp of the magic circle; do they try to compete? do they go the white label route? or do they drop out altogether?

Andrew Hilton
Director
CSFI
Introduction

The foreign exchange industry is not accustomed to the limelight. Usually overshadowed by the more lucrative business done by equity and corporate finance divisions, foreign exchange has often been seen as a dependable but dull cash cow for the banks. But as the handsome profits gleaned from equities and corporate finance have evaporated, foreign exchange departments have been left as one of the few remaining profit centres in the banking sector.

It is not just its profits that have thrust foreign exchange into the centre stage, but rather consolidation. The long process of consolidation appears to be reaching a climax. A game of musical chairs is being played out in slow motion by major banks. Most executives agree that, when the game is over, there will be as few as ten global banks dominating the foreign exchange industry. At stake is a share of the reliable profits to be made from the foreign exchange business.

In order to convert thin margins into fat profits, scale and efficiency are of the essence. As a result, the speed of technical innovation has been furious. The benefits of electronic trading – until recently the prerogative of the banks – are now being extended to institutional investors and companies. It is hoped that within a few years a large volume of client trades will be untouched by human hand – eliminating errors and slashing costs. In order to reach this promised land, the banks have been investing hard. But despite the heroic scale of investment by banks, STP is still some way away and the multi-bank portals set up by the large banks have got off to a slow start. Indeed, Atriax – set up by three of the leading foreign exchange banks – simply ran out of cash.

The next few years, then, will be crucial in the evolution of the FX business. The banks are clambering for a seat at the top table. For those on the margins of the top 10, it is clear that their foreign exchange business cannot stand still; they will either have to expand or contract.

The spot market

Volumes

Spot volumes remain the bread and butter of the foreign exchange industry. This means that, however elaborate a bank’s strategy may seem, the quest for volume is always at its heart. The spread made by the banks on foreign exchange transactions – although wafer-thin - is key to their profitability. Managing the risk arising from these volumes further increases returns. And conventional wisdom holds that the larger the volumes a bank sees, the greater are its chances of making money from holding positions. Plus an added bonus: the informational content of flows is much coveted by the banks.

Consolidation has meant that volumes have fallen into the hands of fewer and fewer banks, with 60 per cent of all transactions now passing through just ten institutions. But while banks struggle to gain a larger slice of the cake, they remain deeply concerned by its overall size.

Predicting the future size of spot volumes is extremely difficult. While banks carefully monitor their volumes, accurate data on the overall size of the market is scarce. Once every three years, the industry gets a snapshot of volumes from the Bank for International Settlements, which collates figures from 48 central banks and monetary authorities.
On the surface, the BIS’s last survey made worrying reading for the foreign exchange industry, with average daily spot volumes falling from $1,490bn a day to $1,200bn between 1998 and 2001. This 19 per cent fall contrasted with the rapid rise in foreign exchange activity reported in all previous surveys. The obvious culprit was the introduction of the euro, which eliminated trading among the 11 members of the European monetary union. Although the new currency was on one side of 38 per cent of foreign exchange transactions – higher than the previous share of the Deutsche mark – this was lower than the combined share of the euro’s constituent members in 1998. Another blow was the fall in volumes from companies. According to the BIS survey, trading between banks and non-financial customers fell from 17 per cent of the market to just 13 per cent. The most likely explanation was consolidation, which allowed more netting of transactions within expanding corporations.

But the fall in volumes also reflected an increase in the efficiency of the market, and hence has no adverse effect on the profitability of foreign exchange operations. The growing use of electronic brokers in the spot inter-bank market reduced the need for foreign exchange dealers to trade actively among themselves. Banking consolidation has also reduced volumes.

“Industry consolidation has seen far more netting and flow aggregation reducing the volumes that are traded in the interbank market, says Richard Moore, head of foreign exchange at Citibank. “Bigger institutions are also willing to assume bigger risks, standing as principals to one side of a client trade without immediately offsetting the trade in the professional market.”

The result has been that the share of overall trading represented by inter-bank activity fell from 64 per cent in 1998 to 59 per cent in 2001. Meanwhile, transactions between banks and financial customers increased their share of overall turnover from 20 to 28 per cent. That is good for the foreign exchange banks; the overall size of the market matters less than the growth of client transactions. Churning of trades between banks adds little value. As shown below, in the wider CSFI survey that was carried out as part of this exercise, this trend is expected to continue:

"Over the next three years interbank spot FX trading volumes will...

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So where to now? Given the complexity of the calculations involved, it is little surprise that there is no consensus among senior industry figures.

Their calculation breaks down into several categories:
a) In an era of booming stock market returns, foreign exchange became a sideshow. Now, it is once again closer to the centre-stage. “When equity markets were rising 20 per cent a year, investors could afford to ignore currencies”, says Peter Nielsen, head of foreign exchange at the Royal Bank of Scotland. “Now, in this low yield environment, every pip counts, and so managing currency risk becomes much more important.”

It is not just preserving often slender gains on an underlying equity or bond portfolio that has been bolstering the use of foreign exchange. Increasingly, currencies are once again being seen as an asset class in their own right. For instance, Paul Fisher, head of the Bank of England’s foreign exchange division, says that falling returns from underlying portfolios have increased the trend towards active currency overlay management, which seeks to enhance returns by taking foreign exchange risk. “In the context of lower returns available in other financial markets, the marginal returns from currency overlay can be very appealing”, he says. This trend should support volumes in the future.

But the weakness of the equity markets is seen by many as a double-edged sword for the foreign exchange market. The falling value of equity portfolios has undermined volumes over the past few years. “As the value of portfolios has fallen, so has the size of the currency trades necessary to purchase new shares or to hedge the currency exposure”, says Paul Lambert, director of currencies and fixed income at Deutsche Asset Management. Neil Record, founder of Record Currency Management, puts it even more starkly: “We are hedging less because there is less to hedge.”

This suggests that a revival in the equity markets would be positive for currency volumes, although a repeat of the equity market boom of 1999-2000 would risk relegating foreign exchange to the sidelines once again. Foreign exchange executives appear to be hoping for a more sober upswing in equities.

b) Even if equity values fail to climb back to the lofty heights reached in 2000 anytime soon, some industry executives are hopeful that portfolio diversification will work its magic. “Overall volumes may even fall below $1,000bn a day, but the buy-side element of trading will increase as fund managers continue to invest more globally”, argues Martin Wiedmann, global head of foreign exchange distribution at UBS. “Five years ago, a US pension fund would have had 90 per cent of its assets in dollars. Now this is likely to be closer to 80 per cent. This trend is continuing and is the same for the global pension fund industry.”

Citibank’s Moore argues that currency diversification will be spurred by weak returns in developed markets. Expectations for returns available in the developed markets have fallen in recent years. The challenges currently faced by insurance, pension and fund management sectors will mean over time that they are more inclined to look cross border for returns not available in their home market.

Many executives argue that volumes in emerging market currencies are likely to increase particularly rapidly. “Emerging market currencies are going to be a very important area of profit growth”, argues Peter Murray, co-head of foreign exchange at Morgan Stanley. As shown below, the CSFI survey conducted for this paper showed 34 of the 58 respondents expecting that overall trading in emerging market currencies would rise. Just four suggested that volumes would fall:
"Over the next three years, overall trading volumes in emerging market currencies will..."

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- **Global trade**: Between the 1980s and the present, growth in global trade has generally outpaced the growth rate of global GDP. In 2000, global trade rose 12.5 per cent, its strongest level for over a decade. But having held up throughout the world recessions of the 1980s and 1990s, world trade growth fell twelve percentage points in 2001. Deutsche’s Paul Lambert argues that, despite this, world trade will hold up relatively well. “There has also been rising trade between regional blocs such as NAFTA and ASEAN”, he says. However, others are less upbeat. For instance, Horst Koehler, managing director of the International Monetary Fund, has expressed concern about decelerating global trade. Global trade growth, he feels, may have slowed to about 2 per cent in 2002, from an average rate of 7 per cent in the 1990s. Some observers fear that, cyclical factors aside, there will be a structural slowdown in the growth of global trade. “Free trade may have reached its limits for a while”, says Neil Record. “The anti-globalization movement, however ill-conceived, does seem to have an impact and there are some signs that protectionism is raising its head in the US.” Overall, the majority of foreign exchange executives interviewed for this paper were not expecting global trade to provide a significant fillip to volumes.

- **Mergers and acquisitions**: Nor do many anticipate a repeat of the M&A boom of 1999 to 2000. This generated huge volumes of foreign exchange transactions, although the effect was tempered by the prevalence of all-share deals. In 1999, foreign direct investment inflows funded around 40 per cent of the US current account deficit. But M&A tends to follow very long cycles. “Most of the companies that wanted to merge have done so in the most recent orgy of M&A”, says Paul Meggnesi, who has recently moved from Deutsche Bank to be currency strategist at JPMorgan. “Many of these mergers are now being unwound and while this may result in some currency volumes being put through, it is unlikely to compare to the volumes generated by the boom itself.”

- **Government bonds**: Even if equity markets remain soggy and M&A fails to pick up, there will be some succor for the foreign exchange markets in rising government deficits – and hence rising bond issuance. The abrupt deterioration of the US budget position – which has shifted quickly from a surplus amounting to 2 percent of GDP to a 2 per cent deficit – is expected to lift cross-border bond flows. Meanwhile, several European governments are bumping up against the 3 per cent of GDP ceiling imposed by the EU’s Stability and Growth Pact.
d) Possible expansion of the EU’s monetary union to include British membership of EMU would deal another blow to volumes. Sterling is still the fourth most-traded international currency. However, foreign exchange executives interviewed for this study mostly view this as a negligible threat over the next three years – a conclusion that also emerged from the broader questionnaire. There are two main reasons for this confidence. First, the incentive for the UK to sign up has been reduced by the lower growth rates achieved by eurozone members. Second, analysts have been highly critical of the policy framework of the eurozone. The asymmetric 2 per cent inflation ceiling set by the European Central Bank imposes a deflationary bias on monetary policy. In addition, the stability pact has limited the ability of several governments, most notably the Germans, to offset economic weakness with a more relaxed fiscal policy. As a result, there is some sort of consensus. “I do not place high odds on British membership of the eurozone in the near future”, says David Puth, head of foreign exchange at JP Morgan. “The very weak economic performance of the zone reduces its appeal for Britain.”

“If the eurozone were enjoying superior growth to the UK it might make more sense”, said John Nelson of ABN Amro. “But there are serious questions about the structures of the eurozone.” Another reason for scepticism over the prospects for UK membership of the eurozone is political. “Tony Blair seems to have his plate full with a range of other issues, including the conflict with Iraq and public services”, said Mr Nelson. “There is a sense that it would not make sense to raise another issue that would be displeasing to the electorate.”

![Graph: "Sterling will join the euro in the next three years..."

Most executives thought that the question of UK membership is likely to be put on the back-burner for the next couple of years. UK membership, they argued, is more likely within the next 10 years.

The prospect of the Union expanding into central and eastern Europe, whilst a threat to volumes in the longer term, is expected to provide a boost to volumes over the next few years. Ireland’s ratification of the Nice Treaty in October 2002 removed the biggest obstacle to the eastward expansion of the eurozone. “We should see a boost to volumes from convergence trades betting on Eastern Europe”, says Mr Neilsen. The rising volume of foreign direct investment heading eastward in anticipation of the expansion of the eurozone should also help lift volumes.

e) A potential threat to volumes also exists in the concentration of trading around the European time zone, according to Chris Cooper of ANZ. “The sustained downturn in the Japanese
economy has been detrimental to volumes in Asia”, he says. “Asia is becoming a dull spot in the 24-hour clock.” Because liquidity is superior in the London time zone, Cooper argues, banks are shifting activity towards this zone. “The market is contracting towards a 12-hour day around the European session. This could add to pressure on volumes and diminish liquidity in the other time zones.”

**Conclusions**

Despite the lack of consensus, several broad areas of agreement do emerge. In particular, many foreign exchange executives feel that inter-bank trading volumes are now stabilizing after the steep fall between 1998 and 2001. The reduction in inter-bank volumes brought about by electronic trading and financial market consolidation is also unlikely to go much further. As a result, any further reductions in inter-bank spot foreign exchange are expected to be modest. Meanwhile, client trading is widely expected to creep higher. “If the BIS did another survey now, I suspect they would have found that volumes have bottomed out and may have even gone up a bit”, says Jim Turley, head of foreign exchange at Deutsche Bank. Chris Cooper expects volumes arising from fund managers and investors to rise by around 30 per cent over the next couple of years.

But with so many imponderables, foreign exchange executives are not pinning their hopes on a rise in overall volumes. Instead, the larger banks are seeing consolidation and market share as the route to higher profits in spot foreign exchange. “Over the next three years, it is hard to see spot foreign exchange as an area of great growth, and on a macro level we do not expect the market to expand much”, says Rob Loewy, head of foreign exchange at HSBC. “But the important thing is that the big banks will continue to increase their share of the market at the expense of medium-sized institutions.”

**Derivative volumes**

The anorexic spread on spot foreign exchange for large trades – and, as shown below, the sense that spreads will continue to narrow – means that banks see scale and efficiency savings as the best way to guarantee increasing returns from this element of the market. But the margin to be made from derivative products is much plumper. Hopes are, therefore, high that derivatives will represent a growing proportion of foreign exchange profits.

Between 1998 and 2001, foreign exchange and interest rate derivative contracts bucked the downward trend in spot currency volumes, rising 10 per cent to an average of $1,400bn a day. In the previous three years, daily business had risen by 44 per cent. However, these figures masked...
Derivatives still look hot...

a split between the two market segments, with business in foreign exchange products declining 12 per cent and interest rate instruments rising by 86 per cent. The BIS, which compiled the figures, attributed this to “a broad shift in hedging and trading practices in US fixed income markets and the creation of a large and liquid market in euro-denominated interest rate swaps”.

Industry executives are broadly upbeat about the prospects for derivative volumes. In the CSFI survey, 34 respondents expected interbank derivative volumes to rise, with just 10 expecting a fall. In addition, 28 expected a rise in buyside derivative trading with 10 predicting a fall:

Those questioned were most optimistic about the future of the interest rate swap market, with 31 predicting a rise in volumes and just six expecting volumes to decline. This appears partly to reflect the trends cited by the BIS in its triennial foreign exchange and derivatives survey. There may also be a cyclical element to the rise of interest rate swaps. The interest rate cycle has long seemed close to a turning point. Ever since the end of 2001, financial markets have been vacillating between optimism over the prospects of a V-shaped recovery in the US, accompanied by a swift rise in interest rates, and fears that the US economy would remain on the cusp of recession. These rapid shifts in interest rate expectations have led to strong activity in interest rate swaps. In addition, government debt management agencies are increasingly using interest rate swaps to reduce maturities and cut borrowing costs. France, for example, began receiving interest rate swaps in October 2001 and by the end of last year was expected to have moved as much as €100bn in the market.
Emerging markets look good...

Foreign exchange executives have reason to be broadly optimistic about derivative sales more broadly. Some, like Mr Nielsen, are extremely upbeat. “Derivatives will continue to grow strongly”, he says. “Growth rates for RBS will dwarf those of any year in my memory.” Emerging market derivatives and longer-dated products are particularly promising.

Despite several high profile disasters – most notably the near collapse of gold miner Ashanti due to a botched hedging operation – acceptance of derivatives by companies and investors has been growing. Fear of these often opaque instruments is giving way to a greater appreciation of their potential to reduce risk or enhance returns. “Yesterday’s complex derivative product is today’s standard product”, says Richard Moore. “With increasing understanding and standardisation, the buy side is more comfortable using derivatives; this, allied to better technology and risk management tools available to the market, suggests that the growth in derivatives use is likely to continue.” The banks themselves have been seeking to foster this growing familiarity with derivative products, offering services to enable them to track their exposure.

Two other trends are expected to underpin the continued growth of derivative products. A theme noted by several bank executives is the breakdown of barriers between asset classes. “There is a growing demand for hybrid products”, says Mr Murray of Morgan Stanley. “Clients are increasingly looking for products that will allow them to hedge risks in equities and fixed income, or in foreign exchange and commodities. Spreads are so tight in commoditised products that banks will begin to offer more of these tailor-made solutions.”

It is not just companies and institutional investors that are demanding more derivative products. Private investors too are expected to become regulars in the derivatives market. UBS is expecting especially strong growth in the market for structured products – designed to offer returns in a low-yield environment. “We are targeting those who are looking for a yield pick-up in a low interest rate environment, but also want a capital guarantee”, says Mr Wiedmann. These products are typically options-based. The underlying mechanism often involves a client selling an option then picking up the premium, which represents the yield pick-up. This can then be structured in such a way that it is only this coupon that is at risk. UBS is developing a product that enables its client advisors to price up such products with little knowledge of derivatives. “This kind of structure is going to be important in boosting derivative volumes”, Mr Wiedmann argues.

Higher margins are not the only attraction of derivatives for the large banks. Many see the growing popularity of derivatives as a force for further consolidation, increasing the lead of the industry leviathans over their smaller competitors. “This is a market in which there are high barriers to entry”, says Mr Nielsen of RBS.

John Nelson of ABN Amro insists that derivative transactions require a closer relationship between bank and client. “You need to understand the problems and issues of your clients and have a knowledge of their balance sheets”, he argues. “Unless you can provide a high level of manpower and expertise, you are in trouble. You need to be a global business in order to provide this kind of service to a client. You need to be focused on providing solutions to specific problems rather than just liquidity.”

The fact that banking sales forces are becoming increasingly consultative and advisory, and less concerned with the simple execution of trades, lends itself to greater use of more complex derivative products.

But there are speed bumps ahead. For instance, debate still rages over whether regulatory changes, requiring companies to report their derivative positions in their financial results, has slowed
demand for derivatives. The introduction by the US Financial Accounting Standards Board of FAS 133 was treated with nervousness by US companies. Advocates of the new rules say FAS 133 is likely to lead to greater confidence in derivative products precisely because the stricter regulation makes them easier to understand. Industry executives are, however, more doubtful. ANZ’s Chris Cooper is one of the doubters. “FAS 133 and IAS 39 may seriously impact derivative volumes for corporates and will deter many from using these products”, he suggests. “Under the new regime, corporates are likely to be much less active, with companies less willing to unwind hedges and re-establish them.”

Volatility

The elixir of life in the foreign exchange markets is volatility. Not only does volatility provide analysts with something to analyse, it enables traders to make money and persuades companies to hedge their currency exposure. Volatility generates higher trading volumes and, therefore, higher profits. “A lack of volatility does make it harder to make money”, says Mr Murray. “There is a strong correlation between currency volatility and foreign exchange profits at the banks.”

No wonder, then, that the lack of volatility cast a pall over the market through most of 2002. Compared with the turbulence of equity and bond markets, currencies were a haven of tranquility. After a brief rise in volatility between April and July 2002 — when traders braced for a crash in the dollar - trading ranges were remarkably narrow.

Between 1996 and 2002, three-month options volatility for euro-dollar averaged 10.54 per cent. In December 2002, it was just 8.55 per cent. Over the same period, the average volatility in dollar-yen was 12 per cent. Now, it is just 9.25 per cent.

So what explains this unwelcome torpor of the currency markets? One explanation has been the increasing synchronisation of the global economy. For the first time since the early 1980s, growth in the world’s largest economies has slowed simultaneously. In the early 1990s, when the US entered recession, German unification was providing a fillip to growth and pushing up interest rates there. Now the US, the eurozone and Japan have all been slowing together. This is part of a broader trend. As trade links have grown deeper and corporate supply chains more international, there has been less divergence in the growth rates between countries. The final element in this tale of convergence, argues JPMorgan’s Paul Megyesi, has been a growing consensus among policymakers. “The recipe for economic success is now widely accepted by policymakers”, he says. “Most countries now have an independent central bank, some kind of inflation target and a broad policy of fiscal rectitude. There is very little policy divergence.” Since movements in foreign exchange are generated by shifts in relative rather than absolute economic performance, the result has been lower volatility.

So what are the prospects for an end to this depressing state of affairs? Commentators are relatively upbeat. “Typically, periods of low volatility are not sustained and there is no reason to think that this time will be different”, says Paul Lambert. “The current position of the world economy does not feel like a stable equilibrium. The world’s largest economy has one of the largest current account deficits in its history. Japanese deflation is constantly increasing the burden of debt and the euro-zone is mired in slow growth. There are big policy adjustments that need to take place.”

Mr Murray is equally upbeat about volatility. “There appears to be a trend emerging in the yen”, he says. “More broadly, in a deflationary environment with interest rates close to being as low as
they can go in some countries, there may be a temptation to use currency devaluation as a tool to reflate the economy. Japan for example cannot push rates any lower and there is even a subterranean debate in the US about the need to see a weaker dollar. Overall, interest rates have become a less potent tool with which to revitalize an economy.”

This optimism has been justified by the start of 2003. The sharp fall in the dollar has revived interest in foreign exchange. With many economists expecting the US current account deficit to top $600bn this year, the dollar’s slide is expected to continue. The independent weakness of the pound has also breathed life back into the ailing foreign exchange market. There is every reason to expect that the torpor of 2002 will soon be a distant memory. This is almost certain to be good news for the foreign exchange industry.

**Spreads**

Ask a foreign exchange executive about the spread in spot foreign exchange, and the most common response is a mournful: “Spread! What spread?” Some have argued that this is disingenuous.

In 1999, several companies complained that spreads – the difference between buying and selling rates for currencies – had risen markedly in a number of currency pairs, particularly between the euro and sterling. For instance, Mars, the confectionery manufacturer, said that its foreign exchange costs in euro-sterling had risen 180 per cent over the comparable cost of sterling/D-Mark trades the previous year. “Our overriding concern is that the banks are operating in an anti-competitive manner, in effect forming an oligopoly to force customers to pay more”, Mars said at the time.

Some commentators attributed this to the steady fall in the number of institutions active in the market as large banks have merged, including Swiss Bank Corporation with UBS and Deutsche Bank with Bankers Trust. Many Japanese banks have also scaled back their involvement in the market. In 1999, James Quinn, chief trader at Tate & Lyle, the food company, agreed: “As more banks are getting into bed with each other, power bases are building. A very few large institutions with controlling power in the foreign exchange market may be able to dictate market spreads and liquidity.”

The British Bankers’ Association quickly retorted that the wholesale FX market was highly transparent and competitive. If pricing anomalies existed, it added, they would swiftly be arbitraged away. “Participants have unparalleled access to a multiplicity of price providers, enabling them to shop around”, said Simon Hills.

The truth may lie somewhere in between. Banks obviously charge different spreads to different clients. “There is a value chain in the spread, and banks are able to extract greater profits out of some clients”, says Neil Record. “Taking a deal from relatively small companies can enable the bank to offer wider spreads. Doing business with an overlay firm such as ourselves offers very slim pickings indeed for the banks.” But overall spreads have been declining, says Mr Record, whose overlay business keeps detailed records of trends in spreads. “Our suggestion is that spreads fell consistently between 1983 and 1996 and have now stabilized but not widened”, he argues.

Paul Lambert suggests that the increasing sophistication of clients has driven spreads lower. “The days when a bank can make money by charging a large spread to naïve clients have long gone”, he says.

Richard Moore said his internal figures confirmed this spread compression. “There are no independent figures on spreads, but if I divide my turnover by my revenue I can see that spread compression is going on”, he says.
The most convincing explanation for this compression lies in the increasing sophistication of a bank’s clients. “Clients simply have much easier access to information and can see for themselves where the price is”, says Mr Moore. “This is not just due to multi-bank portals, but to very robust and easily available market data in general. Deutsche Asset Management, for example, keeps an eagle eye on the spreads it is charged, and has even hired a former bank salesperson to monitor spreads. The fund manager has withdrawn its custom from banks that have consistently overcharged.

So, can this process go any further? As noted earlier, the CSFI survey showed that 25 of 58 respondents thought that spreads would fall further. Some feel that multi-bank portals, which pit banks against each other to service client trades, could further erode spreads. But the top foreign exchange executives are less convinced. Price transparency is already so total that multi-bank portals are thought unlikely to have more than a minimal effect on spreads. For instance, Chris Cooper of ANZ thinks that spreads are already about as lean as they are going to get. “Part of the reason that we are so keen on risk management is because spreads are so narrow.”

If anything, there are suspicions that spreads may widen slightly. This is due to consolidation. Jim Turley, head of foreign exchange at Deutsche Bank, has said that consolidation raises the question as to whether the banks are charging the right price for liquidity. “With flows to the big banks getting larger, and larger, the risk that the banks sometimes have to assume is growing too”, he says. “The probability is that on eight out of ten days the incoming trades will net out – with dollar buy orders matched broadly by sell orders. But there may be occasions when a bank will have to take on a lot of risk to bridge the gap. At the moment, we are comfortable with that. And of course nobody will want to be the first to charge for this liquidity. But this may be an issue for the future.”

**Consolidation**

“For unto everyone that hath shall be given, and he shall have abundance: but from him that hath not shall be taken away even that which he hath.” Matthew, 25:29

Such has been the plight of middle-tier and small foreign exchange banks. Power in the foreign exchange market has become increasingly concentrated in the hands of a handful of giants. This trend was underlined in the most recent BIS survey. In 1998, for instance, 24 banks controlled 75 per cent of turnover in London. By 2001, just 17 banks had taken 75 per cent of the market. In the US, the concentration of power is even greater. In 1998, 20 institutions took 75 per cent of all volumes; by 2001, the lion’s share was controlled by just 13 banks. According to even more recent estimates, the top ten foreign exchange banks have continued to increase their market share. The respected *Euromoney* survey indicated that 44.48 per cent of overall market share is now concentrated in the hands of the top five players. In 2001, they held just 35.82 per cent.

This has partly been the incidental result of bank mergers. But there have been other reasons for the polarization of the market. While some see consolidation as potentially leading to higher spreads, it is more common to cite thinner spreads as a reason for consolidation. Richard Moore argues that spread compression makes it all the more essential for global banks to capture ever-greater volumes. “You need economies of scale and you need to be a low cost provider in this low margin environment.”

“Market share is vital because it reduces your marginal costs”, agrees Mr Wiedmann of UBS. “The infrastructure needed to support a viable business is very great,” says David Puth. “The
problems of Allied Irish Bank showed this. There is no point taking these risks for such slender margins.”

The other side of the equation has been the increasing cost of running a global foreign exchange business. Five years ago, banks were supplying prices over the telephone. Now, in addition to trading over the telephone, they have to provide prices on single-bank and multi-bank platforms. “The technology requirement on banks is increasing”, says RBS’s Peter Nielsen. “The investment necessary now is truly heroic. There are simply the have and the have-nots.”

Buy-side clients are also becoming more choosy and are trading with fewer institutions. As a result, they now expect a deluxe service. “You need bags of professional talent”, says Mr Loewy of HSBC. “You need the full operational gamut to process a deal efficiently. You need high quality research, risk management and compliance. You need to develop an excellent e-commerce offering. To be one of the top five demands a lot of commitment.”

There is an additional problem for the smaller players. “Volume begets volume”, as Euromoney put it in its recent survey. Large volumes give the big players a head start. This start enables them to read the market better, improving the quality of the advice they can give to their clients and enabling them to make larger gains by managing risk. This higher quality service, so the argument goes, makes it easier for them to attract volumes. Market information is like gold dust for the banks.

Small wonder then that the have-nots are starting to question the wisdom of trying to compete head-to-head with the large banks. With the exception of a few regional banks that are managing to establish a niche in their local currencies, many of these medium-sized players are being squeezed out of the market. This presents a golden opportunity for the larger banks to scoop up the volumes of their smaller rivals.

The foreign exchange banks are also increasingly keen to provide white-label solutions to smaller banks – for instance, providing a website retaining the brand of the client bank, but with the liquidity supplied by a larger institution. This is a mutually convenient solution. The client bank can maintain the illusion that it is a full-service bank to its clients without having to shoulder the enormous costs associated with competing in the big league. The advantage for the global giants is equally compelling. For a relatively low cost in connectivity, you can get a substantial build up in volumes. The smaller regional banks can deliver clients that would otherwise be out of reach for the global giant – except those that have tentacles stretching out into the regions. Moreover, there is the added benefit that the client bank continues to vet the creditworthiness of its customers and manage the relationship.

Several banks have been particularly active in this market. Goldman Sachs, for instance, has set up Quote Online, a forex options structuring and pricing tool, targeted at smaller regional and tier-two banks. UBS has also launched a new offering to these smaller banks, called B4B (Banks-for-Banks). “Outsourcing at the moment is the great California land-grab of the foreign exchange market”, says Deutsche’s Jim Turley. “Don’t let any large bank tell you that they are not falling over themselves to get the business of the smaller banks. It is a fantastic way to get flow. It is like e-commerce was two years ago.”

It seems too good to be true. And indeed there are some doubters. Even some of the most active banks are keen not to exacerbate the gains from white-labelling. “There is room for about four or five big players in the US, and that is what the market has”, says Geoff Grant, head of foreign exchange at Goldman Sachs. “The big 10 banks probably have about 80 per cent of the volume,
but they will never get 100 per cent, because some of the regional banks will hold on to their niche.”

An additional worry for banks is infrastructure. “This is one step on the way to becoming a service provider or effectively a software provider”, says Mr Wiedmann. “If the tool goes down, then your client bank will become very upset with you”, he added, whilst acknowledging that systems are becoming increasingly reliable.

Conclusion

But most executives sweep aside such worries. (And it is worth noting that Mr Grant’s estimate of the scale of the volumes up for grabs does not match the Euromoney figures.) Consolidation will, they feel, continue. It is certainly true that the market share of even the leading banks becomes relatively modest just seven places down the Euromoney list: Morgan Stanley, at number seven, has a market share of just 3.4 per cent. This can surely be improved at the expense of smaller regional banks. “Five to seven years ago, Citibank’s share of the market was around 5-6 per cent, and now it is 11.17 per cent”, says Mr Wiedmann. “Consolidation in the banking sector should mean that the number one foreign exchange bank will have a market share of closer to 20 per cent in 2-3 years.”

That said, niches do exist. One such niche is being profitably plied by the nordic banks. The Euromoney survey puts SEB, the Swedish bank, ninth in the global ranking of turnover. Nordea, which has swallowed up banks from Sweden, Finland, Denmark and Norway, is ranked number 17.

But even the nordic tenure is not entirely secure. Sweden will hold a referendum on eurozone membership in September, which is shaping up to be a photo-finish. Although the Danes rejected euro membership in September 2001, some – including Britain’s minister for Europe, Peter Hain – suspect that the people’s verdict will be reversed this year. For smaller European banks, this means that there has been no nook or cranny to hide in. Former specialists in the lira or French franc can either chose to compete in the big league – with all the infrastructure costs that this implies – or retreat to the sidelines and outsource most of their foreign exchange needs.

Because smaller banks will prefer to maintain the illusion that they are providing a full foreign exchange service – maintaining a service on a branded website and continuing to advise clients – the trend towards outsourcing will be largely invisible. Big banks are also reluctant to embarrass their new clients by acknowledging the service they provide. But many see it as inevitable. “After all Calvin Klein does not make his own pants”, said one bank executive.

Even those who are more sceptical of white-labelling are seeking to penetrate the client base of the smaller banks, using technology to access smaller clients. The Royal Bank of Scotland fears that the cost of a large network of white-labelling can be high. “We are trying to reach the end user not by going through intermediate banks, but by trying to go through aggregation points”, says Mr Nielsen. “SMEs often use industry bodies to execute, for example IATA for the airline industry. Many industries have such a touch point.”

This trend towards squeezing out the middle-ranking banks is universally seen as bad news for service providers like Reuters and Bloomberg. Bank executives said both would have to continue to innovate and provide value-added services in order to maintain profit growth. “Vendors need to make their platform multi-product and multi-functional”, says ABN Amro’s John Nelson “We want to bundle all of our services on to one platform so you can flip from FX research to cash management. This should all be on one desk.”
At the end of this process, one’s conclusion has to be that there will be around ten global foreign exchange banks still standing – with another handful sheltering in niche markets.

**Competition**

*Where will the battle be won or lost?*

The balance of power between banks and clients – once heavily skewed in favor of the banks – has been shifting inexorably towards the client. Firstly, bank clients have gained greater access to information. Price transparency has made it hard for banks to charge a large spread to all but the most naive of clients. As a result, there has been not only a thinning of spreads, but also a convergence of the spreads offered by different banks. Call up ten banks and the difference in price will often be infinitesimal.

As a result, the arena of competition has shifted from price to pre- and post-trade services. “Ten years ago, the banks competed almost exclusively on the basis of the spread, with the width of the price and the speed of execution key”, says Citibank’s Mr Moore. Now the key issues for the clients are pre-trade – which consists of research, both macroeconomic and quantitative – and post-trade – meaning the efficiency with which trades are settled. This refrain is echoed mantra-like by all the large banks. Client relationships, they say, hold the key. “The story in FX now is not pricing but solutions”, says John Nelson. “We think about it as providing solutions rather than selling products.”

But it is not just price transparency that is forcing the banks to offer something new. The banks are also losing their near-monopoly on expertise. Increasingly, they are having to deal with currency experts at the fund managers or, even worse, with overlay managers – who have no need of any pre-trade advice. Fund managers are hiring currency specialists from the banks or training people internally to produce in-house research and trading ideas. Paul Lambert – who, as noted, is now director of currencies and fixed income at Deutsche Asset Management but who was formerly currency strategist at Citibank – is one such hunter-turned-gamekeeper. “There has been a change in the relationship between the clients and the bank”, he says. “The fund managers now have more people with currency-specific expertise, so the banks have to create some value that we do not have.”

Client vigilance is also on the rise. As noted, Deutsche Asset Management monitors its relationship with the banks on an on-going basis, with formal assessments every six months. The banks are judged on the basis of research, the quality of their sales contacts, contact with officials, and the spread and the quality of execution. DAM then uses algorithms to calculate the value it extracts from each counter-party, and allocates volumes on the basis of it.

**Research and sales**

*Research has become a key battleground.* Overall, currency research has become much more sophisticated in recent years. Not long ago, simple models of interest rate differentials proved relatively reliable guides to currency movements. Now, with capital flows less dominated by fixed income, the currency strategist has become more eclectic and the discipline has become even more demanding. Nevertheless, the quality of research is mixed. Leading banks are forced to compete for just a handful of talented analysts who are capable of pulling together trends from all other financial markets.
The growing demand for high-level expertise has also made it tough going for the banks. Rather than generic research – distributed indiscriminately to all clients (and to some journalists too) – fund managers are now asking for bespoke research. Often the value-added that banks have to offer is based on their proprietary flows. This, the banks argue, provides them with a privileged insight into the direction of the market. Official data on capital flows is released after a long lag; basing decisions on official data might thus be compared to driving a car through the rear-view mirror.

There are reasons to be slightly sceptical of the cult of capital flows. If you had access to all capital flows, the net result would be zero. As a result, banks often take particular interest in the market’s profit maximisers, those who tend to lead the market. Typically, this means the fund managers. Some fund managers describe the value proposition from flow analysis provided by the banks in disparaging terms. “They are asking me to follow myself, or at least my peer group”, said one. But there is clearly value to flow analysis. Flows help a bank to assess whether a move has been led by speculators (in which case it may be vulnerable to profit-taking or an unwinding of positions) or fund managers (in which case it is more likely to be durable).

Rashid Hoosenally, managing director and head of client strategy at Deutsche Bank, thinks that banks can continue to offer value to fund managers via research. “There has been a shift in the type of research we are providing”, he says. “As the client becomes more sophisticated, we are doing more bespoke research.” The research resources of a bank are still incomparably larger than those of a fund manager, he adds. The result has been a shift into specialization. Mr Hoosenally compares this to the difference between general practitioners in medicine and specialist surgeons. “We have an increasing number of specialists relative to our GPs”, he says. “Our clients are now demanding a combination of traditional macro-economic research, together with quantitative research and systematic processes.” Deutsche Bank has also been developing more clean, numerical financial markets data.

Straight-through-processing

Straight-through-processing (or STP) has become the philosopher’s stone of the foreign exchange market. Efficient processing of trades has been rising up the list of client priorities. The consensus is that those banks able to offer efficient electronic processing are likely to win market share at the expense of the laggards. Those in the vanguard of pushing their clients on-line will also benefit from lower costs, since electronic processing should enable banks to trim their back offices.

STP is perhaps best seen as a spectrum. Technology means that trades can now be fully processed, from pricing to confirmation, untouched by human hand. So far, very few trades are. But a large number of trades now involve some electronic element, with the execution or confirmation processed electronically. Morgan Stanley estimates that around 90 per cent of trades now involve some electronic element, but that only about 5 per cent are totally untouched by human hand.

The main appeal of electronic trading for the client is not price discovery, which is already efficient and easy, but the processing of trades. Electronic processing almost eliminates operational risk, reducing the cost of mistakes and the need to investigate them. Costs can thus be cut in the back offices of both the bank and the client.

This is best illustrated by looking at the processing of a trade by a large fund manager. This is often broken down into a hundred different accounts. In the old world (of only a few years ago),
the back office would have had to record all these tickets and re-key them into a fax machine. This was extremely labour-intensive. Now, the details and the breakdown of the trade can be downloaded and confirmed automatically. Data then flows back into the order management system of the client.

So how far has this process gone? Like the philosopher’s stone, STP has been proving somewhat elusive. “If you had asked me a year ago, I would have said we would have been there by now”, says Paul Lambert. “In fact, it appears as far away as it was last year.” STP depends not just on investment by the banks but also by their clients – and recently fund managers have been slashing their IT investment budgets. “The banks all have systems now, but they are all different systems. It is hard for us to create a system that will dovetail with all the banks. At the same time we need to shift between different counterparties in order to maintain value.”

But automation is creeping through the system, and all the major banks are predicting a significant increase in electronic trading over coming years. Goldman Sachs and UBS, for instance, both estimate that half of their trades now go through the electronic system, around 20-25 per cent of volume. UBS, perhaps the most aggressive of the banks in promoting electronic trading, is targeting an “e-ratio” of 80-90 per cent. Most of the CSFI’s respondents are also enthusiastic – albeit less so than Goldman and UBS (at least in the short term):

Once the heavy IT investment costs have been met, this trend should help to make foreign exchange even more lucrative for the banks. Not only will it cut down on back office costs, it should also enable the banks to process higher volumes without increasing the number of traders they employ. Instead of simply processing trades, bank employees are being liberated to provide higher value-added services to clients. Most of the large banks are not expecting to cut staff. But the composition of FX departments will continue to shift, with fewer pure execution traders and a larger number of sales staff and researchers. “Smart banks will cut back on traders and employ more in customer advisory roles”, says Chris Cooper. Many banks hope that this will enable them to cut back on the amount they spend on trading terminals.

This is a clear challenge to the likes of Reuters and Bloomberg.

“In three years time the population of trading terminals will be down by about 20 per cent”, says Geoff Grant. “They will have to provide higher value-added services, perhaps ones that incorporate risk management features and tools that enable you to put a portfolio on a page and analyse it.”
RBS’s Peter Nielsen expects a broadly similar decline in the number of terminals used in banks, with a fall of 10-20 per cent over the next three years. His suggestion is that these service providers need to offer a more tiered service. “At the moment, I either have a $1,000 a month Bloomberg or no Bloomberg at all”, he says. “Many of these are just used as messaging machines.”

With an increasing proportion of FX staff not needing to trade, there may be a growing market for a more tiered product. ABN Amro’s John Nelson suggests that service providers need to make their terminals more flexible. “Vendors need to make their platforms multi-product and multi-functional. We want to bundle all our services on to one platform so you can flip between FX research to cash management. This should all be on one desk.” ANZ’s Chris Cooper suggests that Reuters and Bloomberg should be seeking to add connectivity between the buy and the sell-side. “They should be looking to e-commerce to lower costs”, he says.

In short, the banks expect to have greater leverage over the service providers – and ultimately expect to reduce the amount of money they spend on their services.

**Threats**

Even for the select group of banks that expect to be in the top ten, there are potential dangers to profitability over the coming years. These include:

**Multi-bank portals:** This may seem an unusual threat. The banks have lavished huge sums creating multi-bank portals, most notably Fxall and the failed Atriax. These sites were the result of strong demand by many clients to be able to select among a variety of providers on the same platform. Although the large banks are publicly extremely supportive of the multi-bank sites and keen to gain their share of the volume, they would prefer to channel trades through their individual platforms. “The bigger players have been supporting the multi-bank portals publicly, but privately flogging their single bank portals”, said Mr Cooper. The merits of this strategy are obvious. Firstly, the bank does not need to share its slice of the spread with a third party – State Street, for example, whose Fxconnect system is so far the most successful of the multibank platforms. In addition, the multi-bank platforms deny the banks the opportunity to build up customer loyalty. The banks’ individual value-added services and tools are showcased on their individual sites.

Unfortunately, the CSFI survey pointed to a worrying trend for the banks. Those questioned believe that the biggest rise in volumes will be over multi-bank portals, rather than single bank portals. Of those questioned, 32 saw a substantial rise in multi-bank trading volumes, while only 22 saw a substantial rise in trading volumes on single-bank platforms:

![Bar Chart](image-url)

**"Trading volumes on multi-bank portals will..."**

- Rise: 27
- Fall: 3
- No change: 20
- No response: 5

CSFI
"Trading volumes on single-bank portals will..."

The potential end-game of this e-commerce development could be to marginalise the role of banks in foreign exchange. Executives are alert to the possibility that multi-bank portals could prove the thin end of the wedge – leading to a world in which companies and fund managers can trade foreign exchange directly with each other, with banks relegated to the role of credit intermediaries. On the IMM, companies can already trade directly with each other.

But Morgan Stanley’s Peter Murray argues that the economic rationale for bank clients to go down this route is far from compelling. The role of market-maker is still highly valued by bank clients. “Also”, Mr Murray says, “the margins are already very, very thin”.

Many bank executives are fatalistic about the speed with which single and multi-bank portals will develop. Both types of platform have a natural audience. Multi-bank platforms appear to be catching on among those who need to demonstrate that they have selected the best price for a deal. In turn, the larger multinationals and asset managers will want a total solution and richer content, argues Mr Cooper.

Credit risk: Another potential threat over the coming years is credit risk. Mr Murray sees this as the main peril for banks in the immediate future. “As we enter a debt-laden and deflationary environment, it will become more risky to extend forward lines to corporates”, he says. “Banks will have to be careful in monitoring their counterparties, especially the Japanese ones.” The solution, he says, is a very strict enforcement of credit controls, and it may also be necessary for some clients to post collateral.

So what does that say about continuous-linked settlement? Executives have a mixed attitude towards CLS Bank, which finally got off the ground last year after substantial delays and a massive cost overrun. The aim was to eliminate settlement risk. Many bank executives privately argue that this is yesterday’s problem. Netting agreements, whereby banks only exchange the net rather than the gross sums transacted between them, have significantly reduced the threat of counterparty risk between the banks. But executives still expect quick acceptance of the new entity, with 29 of those questioned in the CSFI survey anticipating a significant increase in volumes passing through the CLS system.

“In a world in which credit quality is deteriorating, it would be unwise to forget about Herstatt risk altogether”, says Mr Murray.
Conclusion

The foreign exchange market is entering the final stages of becoming a commodity business. As a result, the industry that emerges will be less crowded. Although a host of bank brands will survive, many will be just facades, behind which transactions will be conducted by one of perhaps ten large banks.

Lean spreads will put a premium on processing efficiency. The result will be that an ever-increasing proportion of trading will migrate on-line. Straight-through-processing will play an increasing role in trading. Many smaller trades will be processed untouched by human hand – with currency systems seamlessly embedded into the inventory and supply systems of companies.

These changes will mean fewer traders and fewer trading terminals, shifting the emphasis on to sales and research. These will be the areas in which banks will seek to distinguish themselves. The investment required by banks in research and processing will continue to be significant. For those that fail to secure a position in the top tier, this money will be largely wasted.

The stakes are high.
Christopher Swann has just taken up a new position as economics correspondent at the Financial Times. Prior to that, he was currency correspondent – a position he had held since January 2000. Chris has a BA in history from St. Peter’s College, Oxford and an MPhil in International Relations from Trinity College, Cambridge (where he wrote a dissertation on the PLO). A man of many parts, he also studied advanced piano performance and harmony at the University of Michigan.
Appendix I

CSFI Future of FX & Money Markets Survey

October, 2002

The CSFI (which is an independent, not-for-profit think-tank supported by 65 public and private institutions) has commissioned Chris Swann, the FX correspondent of the Financial Times, to carry out a survey of where the London FX and money markets are going. The results will be published as a CSFI report, probably just before Christmas. The most important parts of the survey will be the results of:

- a questionnaire that we have developed, which will be distributed widely within the FX community (dealers, managers, market users, commentators) in London; and
- a series of interviews with key figures in the market.

Although we are asking respondents to the questionnaire to identify themselves, responses are confidential. Unless you specifically indicate otherwise (by ticking the appropriate box), we will not identify you in our report. That said, it is very important that we get as wide a response as possible. We would, therefore, be very grateful if you could spend a few minutes filling the questionnaire out. Also, please feel free to copy it for a colleague (additional copies can be downloaded from our web-site, www.csfi.org.uk). Please return any completed forms to the CSFI at 5 Derby Street, London W1J 7AB (fax 020 7493 0190).

Many thanks,
Andrew Hilton, Director

Please give us your views on the following statements regarding the future of the FX market; please circle one number only for each statement. The statements have been divided into discrete sections; after each section there is a space where you are encouraged to add additional comments.

For the following statements in this section, we seek your views on what will happen over the next three years:

**FX/MM market**

Sterling will join the euro

[1- strongly agree to 5- strongly disagree] 1 2 3 4 5

One or more currencies will leave the euro

[1- strongly agree to 5- strongly disagree] 1 2 3 4 5

Interbank spot FX trading volumes will...

[1- rise significantly to 5- fall significantly] 1 2 3 4 5

Spot FX spreads are likely to narrow

[1- strongly agree to 5- strongly disagree] 1 2 3 4 5

(Continued on next page)
Buyside (ie corporates, fund managers, etc) spot FX trading volumes will…
[1- rise significantly to 5- fall significantly] 1 2 3 4 5

Interbank FX derivative trading volumes will…
[1- rise significantly to 5- fall significantly] 1 2 3 4 5

Buyside (ie corporates, fund managers, etc) FX derivative trading volumes will…
[1- rise significantly to 5- fall significantly] 1 2 3 4 5

Overall trading volumes in emerging market currencies will…
[1- rise significantly to 5- fall significantly] 1 2 3 4 5

Overall trading volumes in interest rate swaps will…
[1- rise significantly to 5- fall significantly] 1 2 3 4 5

Overall trading volumes in deposits will…
[1- rise significantly to 5- fall significantly] 1 2 3 4 5

Overall trading volumes in forward rate agreements will…
[1- rise significantly to 5- fall significantly] 1 2 3 4 5

Overall trading volumes in overnight index swaps will…
[1- rise significantly to 5- fall significantly] 1 2 3 4 5

Further comments on the market section…

FX/MM industry

For the following statements in this section we seek your views on what will happen over the next twelve months:

Trading volumes on multi-bank portals will…
[1- rise significantly to 5- fall significantly] 1 2 3 4 5
Trading volumes on single-bank portals will…
[1- rise significantly to 5- fall significantly] 1 2 3 4 5

CLS Bank will be successful (ie gain wide acceptance and significant volumes)
[1- strongly agree to 5- strongly disagree] 1 2 3 4 5

Liquidity will become a significant problem
[1- strongly agree to 5- strongly disagree] 1 2 3 4 5

Full STP is a realistic, realisable goal
[1- strongly agree to 5- strongly disagree] 1 2 3 4 5

Further comments on the industry section…

Respondent-specific questions
For this final section we are looking for your own views on the future as they affect your organisation; please leave blank any questions that you feel are not applicable.

Over the next couple of years, the number of dealers you will employ will:

<table>
<thead>
<tr>
<th>rise by more than 10%</th>
<th>rise by 0-10%</th>
<th>remain unchanged</th>
<th>fall by 0-10%</th>
<th>fall by more than 10%</th>
</tr>
</thead>
</table>

Over the next couple of years, the number of customer dealers you will employ will:

<table>
<thead>
<tr>
<th>rise by more than 10%</th>
<th>rise by 0-10%</th>
<th>remain unchanged</th>
<th>fall by 0-10%</th>
<th>fall by more than 10%</th>
</tr>
</thead>
</table>

Will outsourcing of the Treasury functions increase over the next couple of years?
[Yes/No; If yes then please give details] Yes No

If yes, details: ____________________________________________
Has risk management within Treasury become a greater problem in the last couple of years?
[Yes/No; If yes then please give details]

Yes No

If yes, details: ________________________________________________________________

____________________________________________________________________________

Do you plan to trade any new products in the next two or three years?
[Yes/No; If yes then please give details]

Yes No

If yes, details: ________________________________________________________________

____________________________________________________________________________

Do you plan to stop trading any existing products in the next two or three years?
[Yes/No; If yes then please give details]

Yes No

If yes, details: ________________________________________________________________

____________________________________________________________________________

Is instant messaging an important part of your future strategy?
[Yes/No; please give details]

Yes No

If yes, details: ________________________________________________________________

____________________________________________________________________________

Over the next couple of years, do you expect to be trading over instant messaging?
[Yes/No; please give details]

Yes No

If yes, where? Inter-bank? Intra-bank? Bank-to-customer?

In which areas are you looking to make long term cost savings?

____________________________________________________________________________

____________________________________________________________________________

____________________________________________________________________________
Box for further comments on this section…

Name ___________________________ Tel ___________________________
Position ___________________________ E-mail ___________________________
Firm ______________________________________________________________________

Normally, all responses will be treated in confidence. However, we are keen to use attributed quotations in our report. If you are willing to allow us to use your comments as an attributed basis, would you please tick the box below:

I am willing to have my comments used on an attributable basis. [ ]

This survey is supported by a grant from Reuters. Editorial control, however, is entirely in the hands of Chris Swann and the CSFI.
Appendix II

Breakdown of questionnaire responses

"Sterling will join the euro in the next three years…"

Number of respondents

\[
\begin{array}{c|c|c|c|c|c}
\text{Agree} & \text{Disagree} \\
\hline
3 & 26 \\
9 & 11 \\
\end{array}
\]

"One or more currencies will leave the euro in the next three years…"

Number of respondents

\[
\begin{array}{c|c|c|c|c|c}
\text{Agree} & \text{Disagree} \\
\hline
4 & 25 \\
10 & 14 \\
5 & 28 \\
\end{array}
\]

"Over the next three years interbank spot FX trading volumes will…"

Number of respondents

\[
\begin{array}{c|c|c|c|c|c}
\text{Rise} & \text{Fall} \\
\hline
1 & 25 \\
10 & 19 \\
\end{array}
\]

\[
\begin{array}{c|c|c|c|c|c}
\text{1} & \text{2} & \text{3} & \text{4} & \text{5} \\
\hline
1 & 2 & 3 & 4 & 26 & 28 \\
1 & 3 & 5 & 28 & 11 \\
2 & 4 & 10 & 5 & 14 & 28 \\
1 & 2 & 3 & 4 & 5 & 3 \\
3 & 1 & 10 & 25 & 19 & 3 \\
\end{array}
\]
"Over the next three years, spot FX spreads are likely to narrow..."

Number of respondents

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<th>Agree</th>
<th>Disagree</th>
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<td>16</td>
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<tr>
<td>13</td>
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"Over the next three years, buyside (ie corporates, fund managers) spot FX trading volumes will..."

Number of respondents

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<th>Fall</th>
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<tbody>
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<td>23</td>
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"Over the next three years, interbank FX derivative trading volumes will..."

Number of respondents

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"Over the next three years, buy-side (ie corporates, fund managers) FX derivative trading volumes will..."

Number of respondents

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7 5 23 18 10 0

"Over the next three years, overall trading volumes in emerging market currencies will..."

Number of respondents

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1 2 3 4 5
8 5 23 20 3 1

"Over the next three years, overall trading volumes in interest rate swaps will..."

Number of respondents

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1 2 3 4 5
9 2 23 20 5 1
"Liquidity will become a significant problem..."

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"Full STP is a realistic, realisable goal over the next twelve months..."

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<td>1.</td>
<td>“Financing the Russian safety net”: A proposal for Western funding of social security in Russia, coupled with guarantee fund for Western investors. By Peter Ackerman/Edward Balls. September 1993</td>
<td>£40/$65</td>
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<td>2.</td>
<td>“Derivatives for the retail client”: A proposal to permit retail investors access to the risk management aspects of financial derivatives, currently available only at the wholesale level. By Andrew Dobson. Nov 1993 (Only photostat available)</td>
<td>£10/$15</td>
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<td>“Rating environmental risk”: A proposal for a new rating scheme that would assess a company’s environmental exposure against its financial ability to manage that exposure. By David Lascelles. December 1993</td>
<td>£25/$40</td>
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<td>4.</td>
<td>“Electronic share dealing for the private investor”: An examination of new ways to broaden retail share ownership, inter alia, by utilising ATM networks, PCs, etc. By Paul Laird. January 1994</td>
<td>£25/$40</td>
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<td>5.</td>
<td>“The IBM dollar”: A proposal for the wider use of “target” currencies, i.e. forms of public or private money that can be used only for specific purposes. By Edward de Bono. March 1994</td>
<td>£15/$25</td>
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<td>7.</td>
<td>“Banking banana skins”: The first in a periodic series of papers looking at where the next financial crisis is likely to spring from. June 1994</td>
<td>£25/$40</td>
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<td>“Banking banana skins II”: Four leading UK bankers and a senior corporate treasurer discuss lessons for the future from the last banking crisis. November 1994</td>
<td>£25/$40</td>
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<td>“Liquidity ratings for bonds”: A proposed methodology for measuring the liquidity of issues by scoring the most widely accepted components, and aggregating them into a liquidity rating. By Ian Mackintosh. January 1995</td>
<td>£25/$40</td>
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<td>13.</td>
<td>“Banks as providers of information security services”: Banks have a privileged position as transmitters of secure data: they should make a business of it. By Nick Collin. February 1995</td>
<td>£25/$40</td>
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<td>15.</td>
<td>“EMU Stage III: The issues for banks”: Banks may be underestimating the impact of Maastricht’s small print. By Malcolm Levitt. May 1995</td>
<td>£25/$40</td>
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<td>21.</td>
<td>“Banking banana skins III”: The findings of a survey of senior UK figures into where the perceived risks in the financial system lie. March 1996</td>
<td>£25/$40</td>
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26. “Banking Banana Skins: 1997”: A further survey showing how bankers might slip up over the next two or three years. April 1997


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53. "Harvesting Technology: Financing technology-based SMEs in the UK" DTI Foresight sponsored report, which examines what has been done (and what will be done) on the financing tech-based SMEs. By Craig Pickering. April 2002 £25/$40
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