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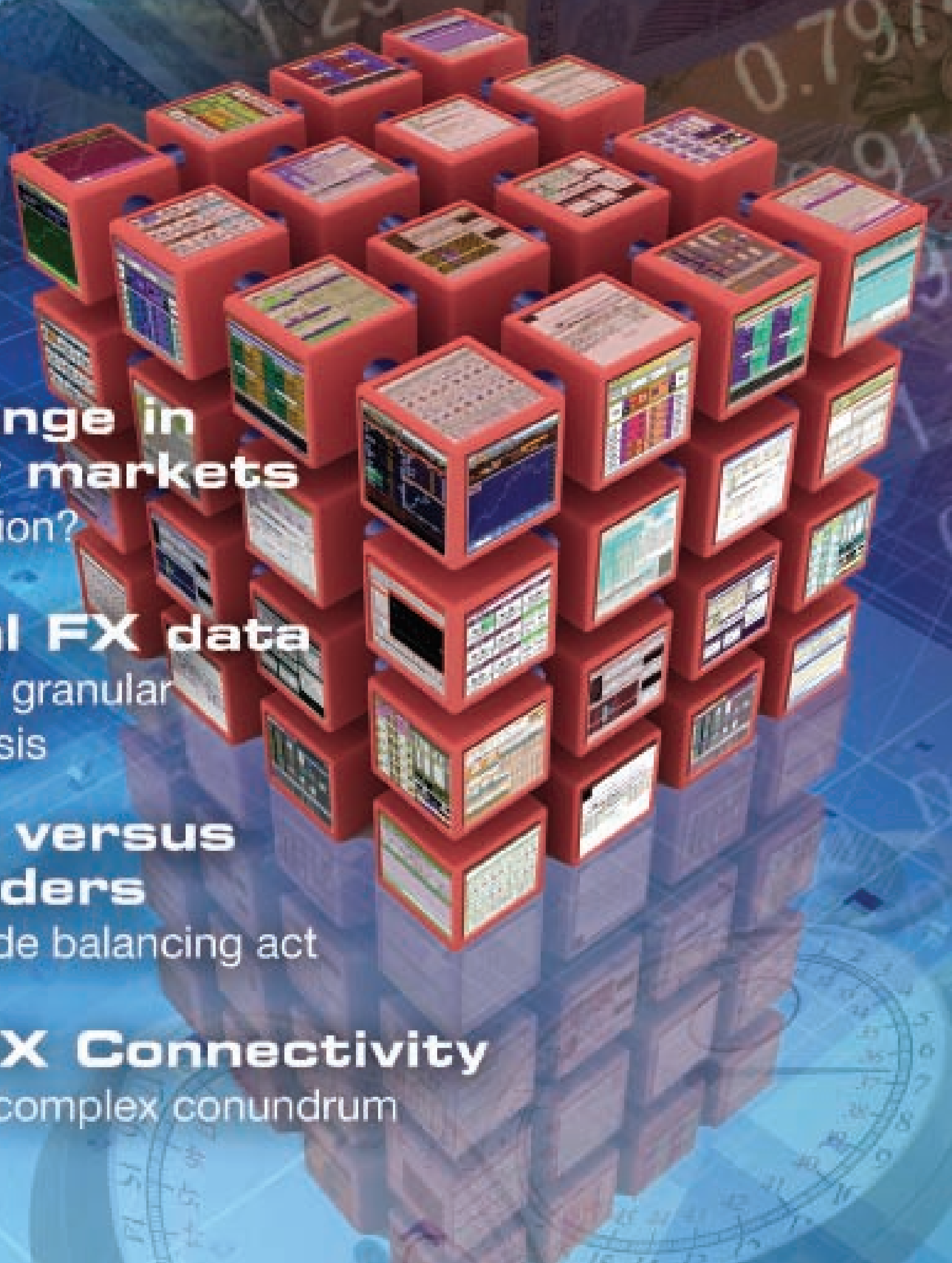

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- a difficult FX sell-side balancing act

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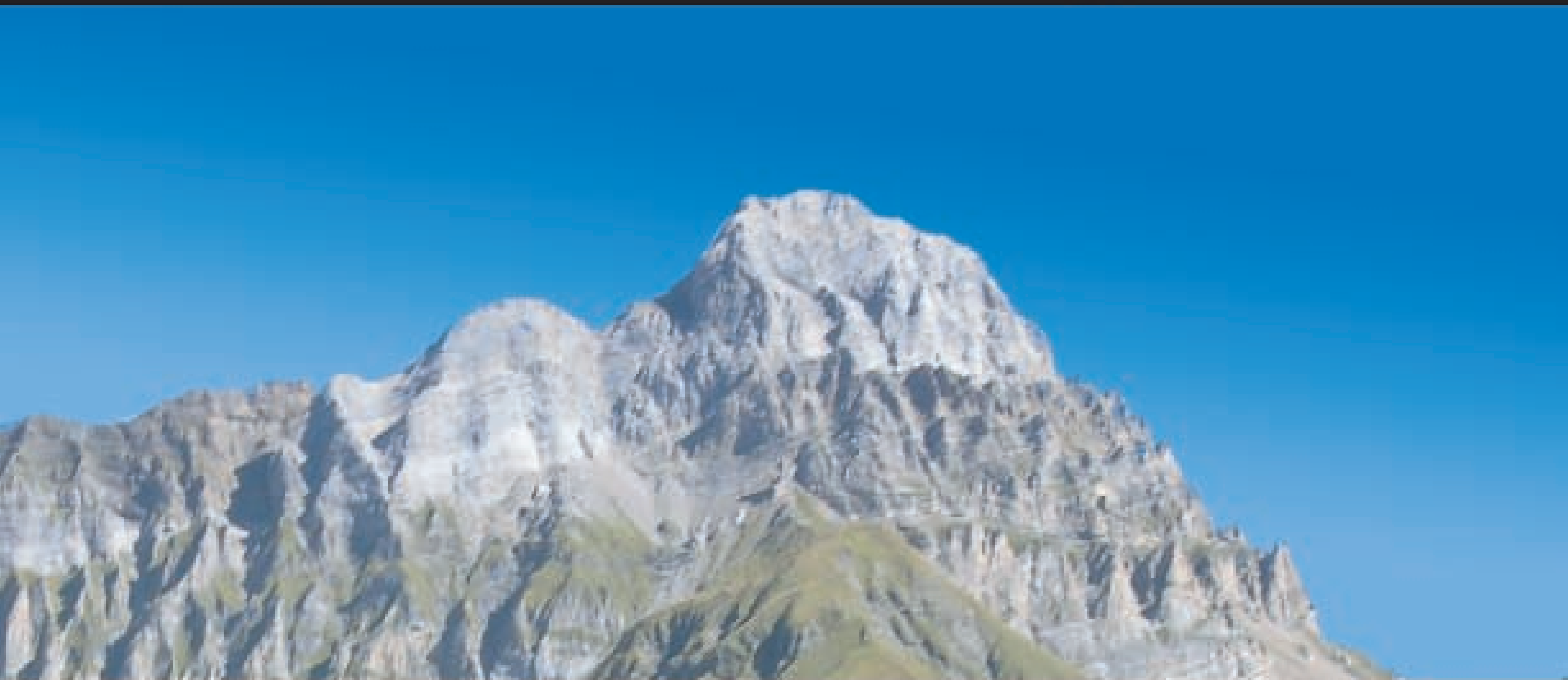


Model-based versus keyboard traders: a difficult FX sell-side balancing act

By Axel Pierron

The development of electronic trading and especially electronic platforms in the forex market has driven out the smallest banks from the market. Electronic trading has increased visibility on the market and reduced volatility, drying out the margins. Today, the FX market is a business of high volume and low margins, which leaves room only for very large institutions and specialists. Indeed, there are fewer banks involved in this market, which is now in the hands of the largest banks, which are becoming bigger and bigger.

In the FX market there are many "buy-side" participants from commodity dealers to asset managers, hedge funds and corporates, that are active in this market for disparate reasons, with different needs and ways to conduct transactions. If we look at the market of electronic trading platforms in the FX market, we can clearly see that those platforms are developing functionalities that meet their customer segment requirements- either asset managers, corporates or hedge funds. From a sell-side perspective, we can broadly divide buy-side institutions operating in the FX market into three segments:

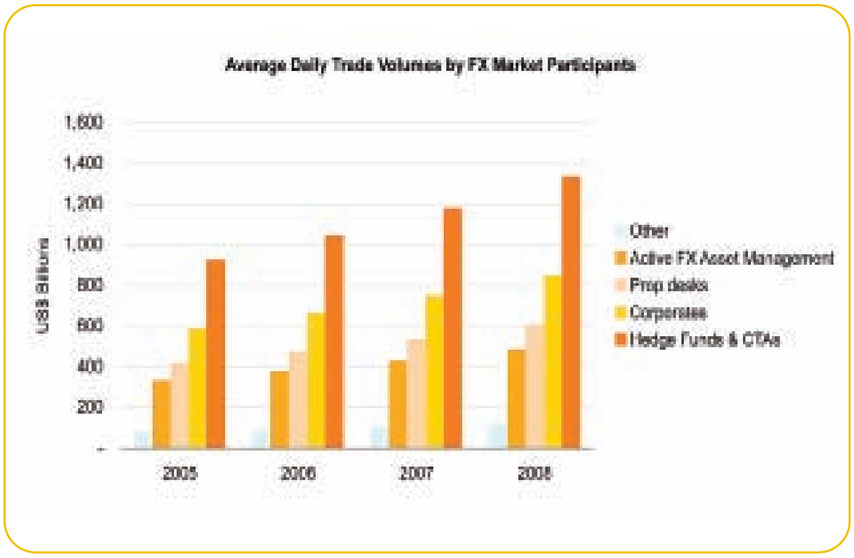
- Large hedge funds, quantitative trading firms and active currency managers. These participants have investment strategies that require them to trade FX frequently and to seek deep liquidity, therefore they now need to receive the same narrow spreads available on the inter-dealer market; in fact they want to be part of the inter-dealer market rather than depend on bank's quotes. In order to be competitive with the banks, some of the funds have written algorithms that capitalize on minute changes in price direction. They will increasingly compete with sell-side banks in the electronic inter-dealer market such as EBS and Reuters.

- Hedge funds and asset managers. These players operate in the FX market mainly seeking for delta and rely mostly on keyboard trading but also model trading. Global corporates that have enough resources in their financial department to be directly trading in the FX market also falls under this category. It will probably be some time before algorithms are used by traditional money managers, such as pension funds or mutual funds, that primarily manage equity or bond portfolios and use FX to settle international transactions

- Corporates executing international trades. These firms use the FX brokerage services of their banks to cover their currency risk. Increasingly these corporates will be served by banks through their working capital management services which links the various corporate services from advices, cash management, trade finance and currency hedging to treasury management . These corporates are not directly active in the FX market but rather rely on their banks services to ensure proper coverage of their currency risk.

Sell-side concern

The importance of the hedge fund industry in FX markets (see figure below) raises some concern from sell-side banks because as opposed to traditional buy-side firms in FX markets, hedge funds are keener to use model trading which impacts the business model of bank's FX trading desk and requires some technology improvements. It is

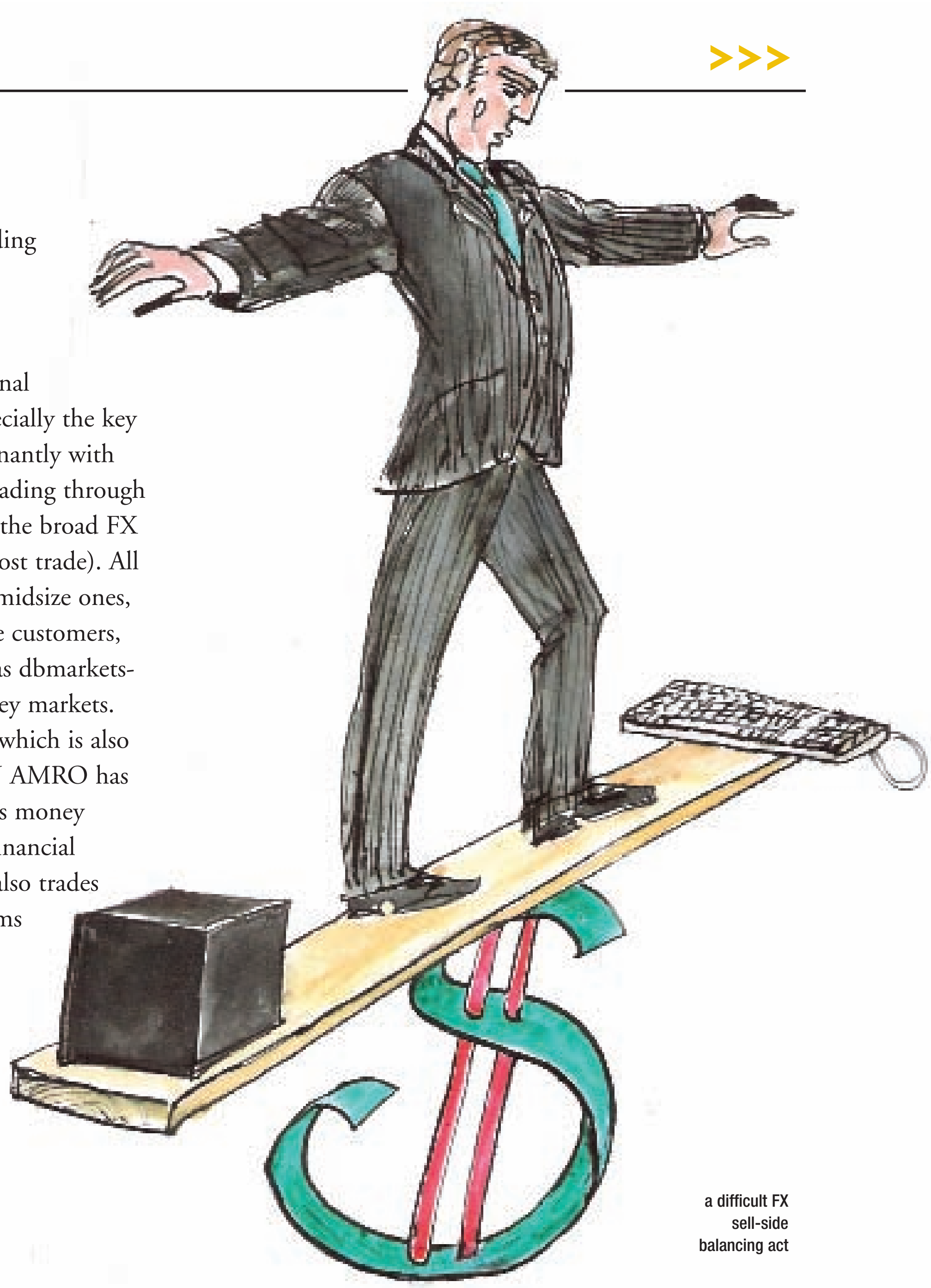


difficult to precisely assess the volume of transactions generated by algorithms, but according to market participants, algorithmic trading is growing weekly. In the interdealer market, we estimate that it represents between 10% and 25% of the volume executed on Reuters and 20% of the volume on EBS, acknowledging that both EBS and Reuters provide prime brokerage services to large buy-side institutions on their inter-dealer platforms.

This is quite a new situation for large FX banks that have for long been the lords of liquidity in the FX market. But the most sophisticated hedge funds are now ahead of the sell-side in terms of using technologies and complex algorithm models to hunt for alphas in the FX landscape. This situation creates some great challenges for banks. First of all, the introduction of model based trading forces banks to improve their pricing engine if they want to avoid being the sheep that would be sheared by large hedge funds, because while banks are looking for betas, hedge funds are going after alphas. And one need to remember that as opposed to other instruments, the FX market is a zero sum game, meaning that for someone to generate profits; someone else has to loose money. Secondly, banks need to adapt their services to serve this community of very demanding but also profitable customers, notably through prime brokerage services. And despite the development of electronic trading platforms, a majority of buy side firms that trade FX online said they use at least one single-bank system. One reason is that they offer certain functionalities—prime brokerage for hedge funds, order management and block trading for investment managers—that remains superior to what is available on most of the multidealer portals.

In fact, FX has become a priority for prime brokerage providers in terms of new technology development and enhancement, and despite being problematic, banks know that technology in this business is a key advantage and therefore expect to increase their spending for these services. (see figures below)

In addition, banks need to continue improving their services to the traditional keyboard customers segments and especially the key relationship clients that trade predominantly with them and continue to send their FX trading through their single dealer site and wish to use the broad FX trading services from banks (pre and post trade). All the major FX banks, and some of the midsize ones, have electronic platforms to serve these customers, UBS has FX Trader. Deutsche Bank has dbmarkets-etrade.com, which trades FX and money markets. Citigroup's online platform is CitiFX, which is also available in a white-label version. ABN AMRO has DealStation, which trades FX as well as money market deposits. The RBS platform, Financial Markets Electronic Trading (FMET), also trades FX and money markets. These platforms will require continuous improvement and updates in the future to adapt to the evolving needs of their users that do not trade sufficient volume to benefit from multi-dealer sites (often those buy-side firms will get better prices through the portals of banks they have strong relationship with).



a difficult FX sell-side balancing act

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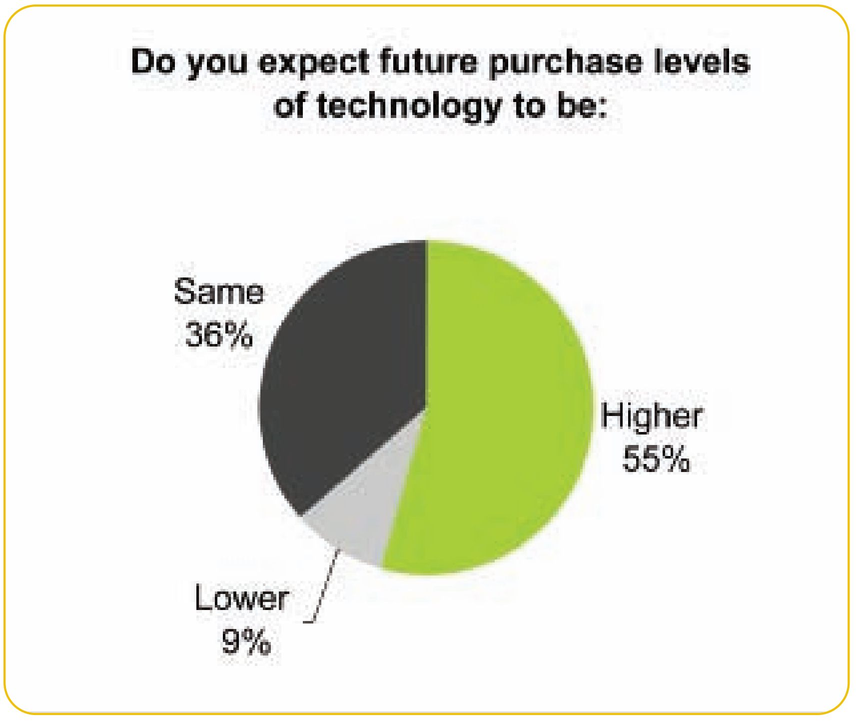
Model based versus keyboard differences

And here begins the difference between high frequency model based traders and keyboard traders. Keyboard traders will still heavily use the traditional services provided by sell-side banks such as pre-trade research and analytics, post trade services such as notification, etc. Model based traders requirement are a bit different, they need to access clean historical data, fast execution and



pricing, they ask for connectivity and fast execution (not surprisingly company such as BTRadianz come into play). Banks are also launching innovative products to facilitate the life of the active customer segment. Citibank has created a foreign exchange index that represents the "market," or beta, available in foreign exchange called Beta1. Beta 1 is now tradable and available on Deutsche Börse and allows investors to benchmark the performance of their FX trading strategy.

It is unlikely that the improved prices provided to model based trader will benefit the keyboard trading customers since they do not generate enough volume to receive similar prices to those available in the inter-bank market. For this customer segment, banks will continue to offer the same currency pairs that they trade with other banks on inter-dealer market, attaching commissions in order to cover their operating expenses. This might not really impact the relationship that banks have with those traditional traders since the bank provides many more services that their customers are willing to pay for through increase prices. Nevertheless, this situation might become an issue under MiFID.

In the meantime, electronic trading will increasingly lead to transaction of smaller value, which will certainly create headaches for the back and middle office in the sell-side banks that will need to cope with an enormous number of transactions and avoid bottlenecks and errors, that could dramatically impact their operational risk.

Conclusion

To summarize, the major evolution in the market is the appearance of buy-side clients that are now actively looking to generate alphas on the market and that trade sufficient volume to receive similar quotes as the ones available on the inter-dealer market.

This requires banks to adapt their technology and services to serve those customers in a profitable manner. And because it is unrealistic for a bank to be everything to everyone, they will need to clearly segment their FX brokerage services to match each customer requirements and that will eventually have an impact on their IT budget. Nevertheless, banks are not just reactive to the evolution, they are also launching counterstrikes.

Banks are starting to compete with buy-side firms, especially currency active manager. Deutsche Bank has recently launched a new product called DB Currency return (DBCR) index that allows investors to gain exposure to a benchmark index with a series of FX model strategies that should in theory replicate the added value of an active currency manager. Merrill Lynch has launched an "FX Clone" methodology designed to replicate FX strategies such as carry trade, momentum, etc.

It might soon become difficult for active currency managers to claim high commission for their services while sell-side banks provide cheaper way to receive a similar service.