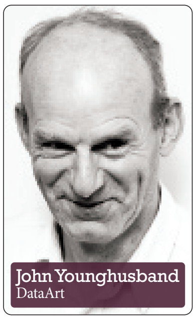
A CHANGING MARKET



John Younghusband of DataArt reflects on how technological developments have changed the face of FX trading.

As with the stock and commodity exchanges, where new technology has increasingly replaced the traditional open outcry market floors, in foreign exchange the old methodology of banks trading desk-to-desk via dedicated private voice circuits is gradually disappearing. Recent growth in program computer trading is the result of technological developments; a combination of greater computing power, lower telephony costs and "fibre to the kerb" provision for faster connectivity.

Significant volumes of FX trading are done entirely electronically. This change in trading methodology started with the launch of screen trading systems by the banks themselves, such as Deutsche Bank's 'Autobahn' and Barclays 'BARX' in the late 1990s. This touched off an arms race in the industry which continues unabated with the emergence of a plethora of competing platforms, each boasting new features and technological advancements.

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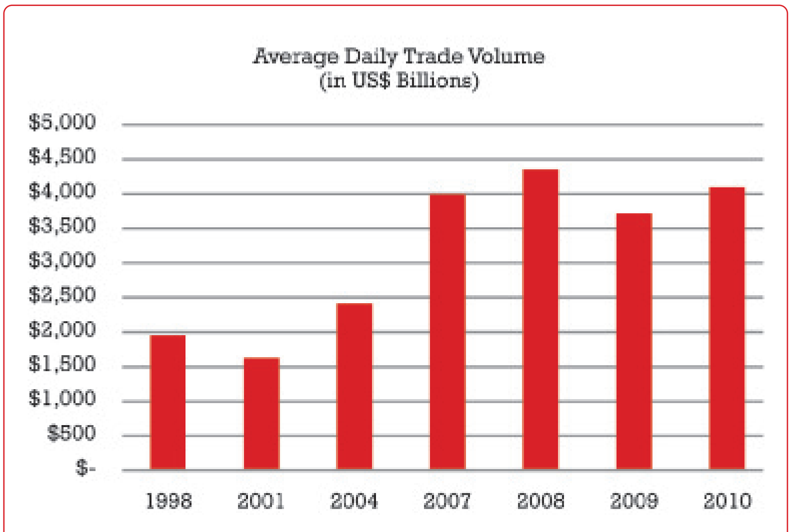

Figure 1: Growth of Global FX Market

Source: BIS, Bank of England Foreign Exchange Joint Standing Committee (JSC), New York Foreign Exchange Committee, Singapore Foreign Exchange Market Committee, Canadian Foreign Exchange Committee, Tokyo Foreign Echange Joint Standing Committee.

New market entrants

The growth in automated FX trading has come about through new market entrants, including hedge funds and corporates trading direct, as well as the growth of CFD trading. Many of the 'new kids on the block' are former traders from major banks who have established start-up FX trading operations on their own. A number of successful international payments firms have also entered the market.

This has led to a narrowing of spreads, making the market more attractive and more efficient for an ever larger group of investors and, dare one say, punters. The other comparable product that has seen phenomenal growth in both online and mobile trading is spread-betting. In the UK, firms like City Index, IG Index, Betfair and others have invested significant sums in technology which allows their clients to access markets both via the web and via mobile apps.

A resilient market

The FX market has shown remarkable resilience since the onset of the global financial crisis. It has carried on largely as usual with no major hiccups, albeit this has been achieved with a fair bit of help from central banks who ploughed in liquidity when it was most needed, enabling trades to be settled as usual. An important role in preserving market integrity was played by both futures and options exchanges, and clearing houses,

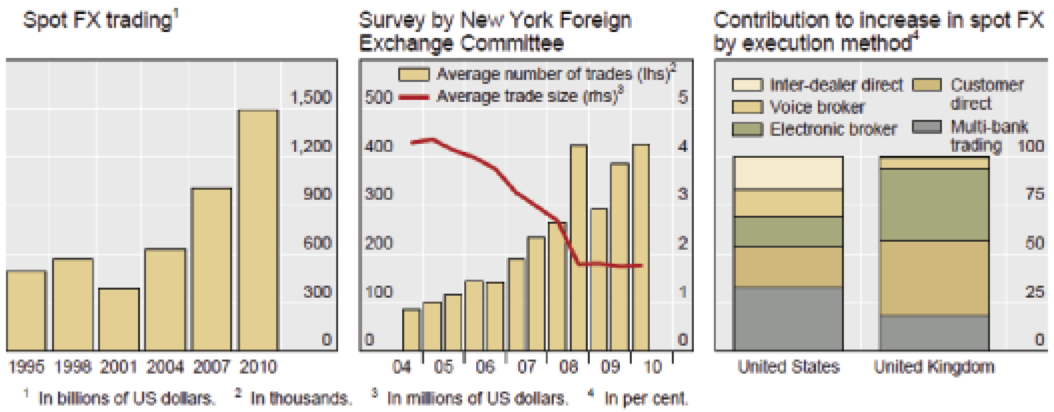

Figure 2: Evidence of high-frequency trading

Sources: Triennieal Ccentral Bank Survey; New York Foreign Exchange Committee

during the crisis. They managed to clear trades even when big investment firms such as Bear Stearns and Lehman Brothers were collapsing.

Steady growth

The global FX market grew steadily in volume terms between 1998 and the onset of the global financial crisis in 2008. After a reduction in volumes in 2009, growth returned in 2010 and all the indications are that the long-term upward growth trend has resumed (see Figure 1 opposite).

Security, risk and compliance issues

For reasons to do with risk, security and compliance some banks are not participants in FX trading through the cloud. Interbank trading still largely takes place via voice through point-to-point private circuits, routed through the dealer boards. Calls are also routed through systems which record all phone calls to the dealer floors of banks. A number of regulators have a requirement for the recording of all mobile conversations to front office staff in the capital markets business.

The regulatory authorities do not have a great track record in terms of their ability to spot problems in the markets and act quickly enough to prevent major failures. Part of the problem for regulators is the fact that the speed of electronic trading and the globalisation of markets has also had a massive effect on the speed of disasters. The "too big to fail mantra" means from a 'market at risk' perspective, that central bank intervention is often vital to hold the market together, as fear and panic can quickly spread across global markets, as they did in 2008.

Device limitations

For mobile FX trading the reliability of mobile connectivity remains a problem – the City of London, for example, has lots of mobile black spots, though Wi-Fi is increasingly available and is becoming both faster and more robust. The arrival of 4G networks should see data transfer speeds increase and bring improved network reliability. There are other functional issues with mobile trading, including battery life and screen size on some devices – on a small mobile device it is difficult to display all of the key market information that a trader would use to inform a trading decision, certainly compared with what is possible on a full-sized trading-screen.

The future

The overall FX trading market has grown rapidly in recent years, partly because of a lack of better investment opportunities and increased volatility in world bond markets, but also because smaller players have found the market increasingly accessible. This has a lot to do with new technology and the arrival of HFT in spot FX trading has been a factor, as Figure 2 illustrates.

As telecoms companies roll out new superfast fibre optic connections to global markets which will further reduce time delay of price retrieval and execution to milliseconds, this will have a significant impact. The expectation must be that new technology will lower the barriers to entry and attract new players, which in turn will lead to further growth in the market.

Further information...

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