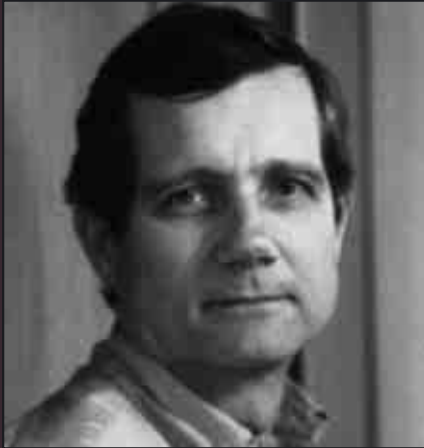


# What's a customer?

## Electronic FX converging the Buy and Sell side



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*Historically, Foreign exchange, almost certainly the oldest financial business, was organized around three types of players: Clients carrying underlying FX exposure, Banks providing prices and credit to these Clients and Inter Dealer Brokers (IDB) insuring information flow among Banks and matching of the banks interest. This structure, traditional in OTC capital markets, has been eroding quickly in the last few years and has been replaced, practically if not officially, by a new market structure that integrates the technology advances of E-FX and better answers the new requirements of the market participants. This new structure, described below, drastically modifies the market by reorganizing it around three key competences: Liquidity provider, Credit provider and System provider.*

This evolution has fundamentally affected the traditional definition and role of Buy side and Sell side players. Some players, such as very large hedge funds, have the know-how today considering many of them were former bank traders. They also have capital (through leverage) and risk limits that are sometimes even larger than banks, allowing them to become significant liquidity providers if they choose to do so. Even more important than when they look for liquidity is where do they look for liquidity? Nowadays, it is not always directly with banks. Anonymous venues have started to normalize participants as "destinations" and chances are the Buy side will be matched with another Buy side on these venues.

This phenomenon of "market internalization", traditionally performed by banks, is now becoming center stage and open to third parties. At the same time the privilege of information and access to interbank pricing that banks enjoyed historically has eroded as clients now can access EBS prices for instance. Finally, to the one to one credit relationship maintained by the Buy side with its FX counterparts originally has succeeded a multi lateral organization of the settlement process. A Buy side will trade with one liquidity provider and settle through a prime broker, which will potentially cross collateralize its FX risk after netting with other financial instrument positions. A market structure based on regulatory and historical definition has succeeded a market structure built around three key functions that are assumed at different time by different players indiscriminately. What are the technology trends that have provided the framework for this Buy-side/Sell-side role convergence? We can distinguish three main ones:

### 1. A revolution in the gathering and distribution of transactional information

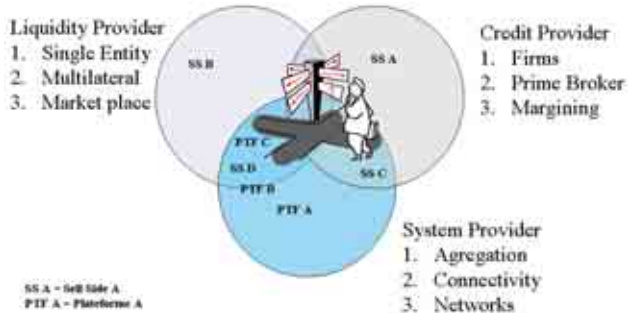
The FX market has started its revolution. As always in times of revolution the innovation rate increases enormously, then a re-structuration takes places taking the best of the old system and the new one to create a new level of efficiency. This is where we are today. If we follow the electronic trading experience curve, FX made its revolution after the Equity market and is converging in many ways towards the same model while keeping some of its more unique characteristics, such as its enormous, globally distributed liquidity pool. The key drivers behind this new transactional efficiency have been the introduction of first

### The Old Market Structure





## The New Market Structure



generation platforms (FXAll, Currenex, etc) simplifying access to the traditional counterparts followed shortly by anonymous liquidity enhancing platforms (HotSpot FX, Lava, EBS, etc) all based on a concentration of the liquidity in one single system.

The current drivers: progressive establishment of the FIX protocol in FX and development of cross asset class platforms like TradingScreen, are moving the market towards a multi lateral aggregation of liquidity by using the global networks that have been established over the last years. These new approaches have normalized the market across Buy side and Sell side in terms of access to information and speed of execution, making strategy building and execution as efficient for both sides of the market. The FX market, historically one of the most efficient OTC markets, thanks to these new approaches, has advanced even further in terms of transparency, information distribution and operational efficiency.

### 2. A progressive reorganization of liquidity

Liquidity was historically one sided, provided exclusively by the Sell side and backed mainly by capital. The liquidity today is getting ruptured in various pools that are competing for the client's interest and can be generated by capital as well as technology to a certain extent. Liquidity today is offered by Banks but also inter dealer brokers (EBS), anonymous platforms (Lava, Hotspot FX), Listed Derivatives Markets (Globex), and in some cases by access platforms (Currenex, FXAll). All these venues can now be accessed in a fraction of a second with the same interface and are de facto aggregated.

On the other side of the market more and more clients are building algorithmic engines that are "listening" real time to the market and effectively give or take liquidity from the market but also arbitrage prices imposing a strong discipline on the various electronic pricing systems. Some of these client-developed systems are becoming quickly a significant source of liquidity but they also make the liquidity equation that much more complex. At the same time the traditional internalization of flows that was done by banks across their client base has been now amplified by a growing internalization of flows by some platforms, especially in the retail sector, adding yet another rupture to the centralization of liquidity. To have a view of the future in that area it is interesting to look at markets where "market impact" is important, such as the equity market. The successful development of Alternative Trading systems like Liquidnet,



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organizing large trades between the Buy side players, shows that it is not far fetched to think that the same market organization could have some application in the FX market and would have a major impact on liquidity by creating just another separate pool to access.

The liquidity chase is therefore more vital than ever in the FX market. Finally, another important element when analyzing liquidity is that today the liquidity is accessible progressively by all players due to the decreasing costs of transaction technology and the numerous credit enhancement facilities that are prevalent in the new model. In summary, both the Buy side and Sell side are faced with the same growing need for liquidity aggregation, but in this new market configuration there is less of the traditional two tiered access system.

### 3. A reallocation of the credit function

Credit was perhaps the single largest limiting factor to the universal access to the FX market, as counterparts historically worked together based on a reciprocal recognition system reducing leverage and trading. Credit was highly concentrated in the banks balance sheet and only the most credit worthy counterparts could access the market. Among the main factors which have structurally modified the credit issue in the FX markets are risk reducing strategies such as netting and improved settlement risk management.

But the main revolution has been the advent of multi lateral execution combined with centralized clearing through a prime broker. This added to margining capability and cross collateralization across asset classes has allowed very active new entrants to the markets like alternative asset managers to enjoy an almost unlimited access to the market by delegating credit management to a few key Prime Brokers that had the technology to offer this service. Technology has allowed players to effectively split each FX transaction into a credit based operation and a trading operation if they wished to do so. This allowed a specialization of the "fittest" participant, building on each players' strengths (Market Making, Credit, Operations, etc) for the greater efficiency and overall good of the market. Furthermore the credit decision for FX has become, with the development of portfolio risk calculation (Span, VAR, etc) and

the establishment of a more global view of banking relationship by the Buy side, more entangled in the entire activity of the client and less specific to the FX activity. This has reallocated the credit issue between the executing counterpart (Bank or platform), the credit supplier (Bank or Prime Broker) but also the client, which can manage its activity through gearing, and correlations to better use its capital. This is a far cry from the traditional one-way street that credit constituted in the past in the FX market.

### Conclusions

The role of the Buy side and Sell side will inevitably blur further in the future as these evolutions reach maturity. The FX market will eventually follow the main model of the future for most financial instruments whereby a network of loosely defined destinations or participants will become the market and where liquidity will be split across a wider number of participants. Automats will permanently scan this liquidity and its patterns and algorithmic trading will take advantage of any opportunity while optimizing the "market impact" of trades. This will imply a reduction of the trade size, a multiplication of the volume and a greater specialization of the players on one or more of the three key functions: Liquidity provider, Credit provider and System provider.

Players that are judged by the market, as not bringing any value added through one at least of these three elements will be marginalized. As electronic access gets cheaper and easier in the future, platforms will have to justify their role in liquidity gathering or back-end processing. As margining systems makes control of risk limits easier and less capital intensive, credit providers will have to justify in a more exacting manner their superior processing and credit enhancement capability. System providers will have to bring real benefits in terms of access, speed and strategy creation to retain the client interest. All the components of the future of the FX market are almost certainly contained in these ideas, which are reaching out to other asset classes. The traditional separation between Buy side and Sell side will progressively give way, through specialization and automation, to a trading world where every player is the Sell side of some and the Buy side of others.

