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THE EVOLUTION OF THE FX MARKET

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Regulation, counterparty risk dominates concerns in the global FX market

As part of a thought leadership series, The Bank of New York Mellon sponsored the latest of Global Investor's Editorial Forums, to discuss the state of the FX markets after the credit crisis of recent months. Editor *Caroline Allen* chaired the discussion and wrote this report.

The past nine months have proved tumultuous for the FX markets but the crisis has provided an opportunity for many players to take a long look at what drives the market, and what the future should focus on. The period since September 2008 was quantitatively and qualitatively different from previous upheavals.

Setting the current crisis in a historical content, participants recalled the mid-1980s, when the primary need for investment managers was to run a more diversified portfolio. Fixed income managers became far more interested in foreign exchange markets, and the sector moved from being driven by corporate

treasurers to being driven by the fund management industry.

A decade later, it was the hedge funds that were major players in the Asian crisis and the collapse of Long-Term Capital Management in the US. By 2001, in the new Millennium, the strategies among the foreign exchange reserve managers of major nations such as China and Russia became the focus of the market.

So what is the elemental change that the credit crisis will throw up? What new customer base, what new group of players will arise that are not yet taken into account?

Historical parallels

Some managers see a parallel between the present sit-



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uation and that of Japan in 2001. As the government embarked on quantitative easing, Japanese investors started pushing their money overseas, either via fixed income products or, in the latter stages, via the FX markets. Will investors in the developed nations now do the same thing?

Participants at the Forum agreed that most G7 nations are likely to be stuck in a prolonged period of economic weakness. "I think the notion that liquidity could seep out into areas of much stronger economic growth, in particular emerging markets, and in particular Asia, is obviously something people are focusing on, and rightly so," said one guest.

The FX market, in contrast to the credit markets, has weathered the recent tumult well, maintaining

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liquidity in all the major currencies, and a lot of the smaller ones as well. That resilience will certainly continue to attract investors.

However, government bond markets will sap liquidity quite in the next few years as they battle domestic deficits. While Japan had a large savings market able to absorb heavy supply, the US, Europe and UK don't have the same domestic savings levels.

Reserve currencies

Talk of a new global reserve currency is widely considered premature. "I think there's probably another step to take first. It's probably true that the G7 economies have taken us into this crisis, but it's not going to be them that'll necessarily take us out, and we've got to look at the emerging markets, at China and India, before we can really think about a new reserve currency," said one participant.

The major "emerging" nations might have to float their currencies to achieve the economic growth they need. Once China's currency floats, the nature of the global FX markets will change. Participants agreed that has to happen "sooner rather than later", and certainly in the next five years. The Indian rupee might follow, becoming one of perhaps five or six global currencies, rather than just the yen, euro and dollar. The present crisis has probably accelerated these developments.

The shifting definition of an 'emerging market' may come down to the maturing of that country's currency. A market is 'emerging' as long as the fund flows are mainly inward. As soon as the flows reverse, with locals investing abroad, it becomes a developed market, a capital exporter. Notably, by that criterion, China and Russia, among other countries are "developed" already, given the fact they've got \$2.4 trillion invested elsewhere.

Forum guests decided that the idea of a new Special Drawing Right (SDR), issued and run by the International Monetary Fund (IMF) is probably primarily a political construct. "Although there's sympathy with the idea of an informal basket of currencies, I can't see why the IMF would be prepared to take all that currency risk off China or Russia or anybody else and accept it themselves. There's no reason why they can't mimic the SDR in the make-up of their foreign exchange reserves...perhaps that's going to be one of the defining stories of the next five years," said one.

Replacing global financial institutions, or creating new ones, is notoriously difficult, but it is clear that the G7 group of most developed nations is going to have to cede some influence within a wider G20. Some participants have already noticed a stronger policy tone coming from the G20 than the G7, and characterised the two as 'old money', on the decline (the G7) and 'new money', in the ascendant (G20).

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The question of a global currency is also not simply about paper reserves, but which currency prices the global commodity base. At the moment, that is still the dollar, the currency with which high-growth nations fund commodity purchases. Signs of these nations diminishing their currency reserves would be a signal to watch.

The fate of the euro is still a focal point. With the evident rise of nationalism around Europe, and the pressure the global downturn has exerted on the component economies within the European Union, the euro is flagging. But in the financial sector the path back is considered worse than the way ahead. There is now little political support for breaking up monetary union. While some countries may be keen to get out of Europe – like Ireland – others, like Iceland, are desperate to get in.

For EU “core” countries, exasperated by the laggards, the solution is probably to drag the peripheral nations closer to the centre, rather than allow them to drift away. If that support works, it may be a catalyst for a stronger, not a weaker euro area long term. The euro, although not the global commodity base currency, has proved it can stand up to the dollar. Emerging market nations collectively are thought to have some 30% of their funds in euros.

Another factor critical to reserve currency status: liquidity. Although not as actively traded, the European government bond market is slightly bigger than the US government bond market, and more importantly, is deepening. If China, for example, decided it wanted reserve currency status, it couldn't, because there is not enough paper for investors to hold.

FX market liquidity, client behaviour

For most FX players, the impact of the last few months has been apparent in changes in market patterns and client behaviour. The words “chaos”, “mayhem” and “distrust” do not begin to describe what happened.

Volatility increased sharply, with sizeable net outflows. Many institutional clients sustained significant dips in assets under management, directing slowing flow within the FX markets. “We went through a period of great uncertainty, particularly in the forward market when we were jumping around like the spot market,” said one participant. The forward market almost ceased, nobody knew where the price was, trade volume and size plunged and trading even in mainstream markets became very expensive.

But activity never dried up entirely. “Remember 1992, during the second half of the year, anyone attempting to trade in Spanish pesetas, forget it,” recalled one guest. “Think back to 1998 and post that dramatic unwind of the carry trade that took place in early October, when everybody's credit line seemed to

be clogged up on the spot.” Throughout the past nine months, the market held up remarkably well.

By the first quarter of this year it started to stabilise. But trading desks active in the forward markets have been constrained by banks trying to charge to use their balance sheets, since they themselves were under pressure. Some of the biggest investment banking names have suffered severe reputational damage, and new players are expected to emerge. Banks with a traditional strength in FX are likely to win new business, as they retrench to core competencies and clients become more cautious.

But will that mood endure? Is it a temporary shift or a long term trend? Pension funds have clearly moved towards more low-cost passive strategies where they either want or accept foreign currency risk. Some managers have observed a higher churn as investors seek higher returns and become less tolerant of even short term underperformance. Passive currency management does not mean doing nothing, however. “That is increasingly risky, like standing in the headlights of an oncoming car and doing nothing,” said one manager. “You take a risk with passive management. People are going to realise that, where it may have been confused in the past with a no-risk or low-risk strategy.”

A distinct move to more global rather than national strategies has also driven FX flows. Initially there were stronger flows as investors moved to cash, but that quickly slowed so that volumes came down by anywhere between 25% and 40%, with the consensus at the lower end of that range. And that is in contrast to a “normal” growth of up to 10% a year. In fact, participants suggested trade flows and spreads are now nearly back to what they were a year ago, even if trade sizes remain smaller. The turmoil is beginning to look like other cyclical downturns, with a necessary “cleansing process” before confidence returns.

“The difference this time,” said one manager, “is that as opposed to '92, '98 and 2001, every market went wrong at the same time. There were major, major





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issues in every asset class and that is unprecedented... it was a Greatest Hits of all crises.”

With time, those players who exited the FX markets are expected to return, because they have to. But they will need to look at new markets, new clients and new strategies. In the past getting the dollar-yen and the dollar-euro trade right has been most important but what hurt people most last year wasn't those, it was getting the aussie-yen trade wrong. Calling the smaller markets right will be important.

Counterparty risk

New markets suggest a whole new range of counterparties at a time of greatly heightened counterparty risk. “There has to be a global approach to it, ongoing credit analysis, you have to expect more regulation around all this,” noted one participant at the Forum. “It starts off being best practice but later on the regulators will catch up and enforce best practice.”

Collateral management is also being revived. FX markets are beginning to get to grips with ISDA terms, CSAs and posting cash collateral, which until recently were only rarely required. Many institutions are now very focused on strong settlement arrangements with the counterparty, because they want a net settle. The CLS system will develop further as everyone starts to co-ordinate the collateral they hold with

various counterparties.

The form that takes is as yet undetermined. Who will create the standard and the operational support for collateral management? The two main views are that it will either be regulatory authorities or private networks of involved banks, driven by clients, who want greater scrutiny of counterparty risk, and that the whole FX market will benefit. CLS doesn't go quite far enough, because it doesn't guarantee settlement with both sides, and it moves the risk to the P&L, it's no longer a gross risk. Many trades are still settled gross, which opens the parties up to unnecessary risk, when CLS exists.

Collateralisation

An even bigger question and challenge, is the collateralisation of the FX market. That has been very slow to develop because people didn't have the appropriate concerns relative to other asset classes, but it's going to grow exponentially in the near future. The buy-side will need to understand a whole new dynamic, and the market may suffer initially.

Corporate investors are likely to rely on their traditional banking relationships to determine what collateral is posted and how, while asset managers will be talking to their custodial banks, and the collateral required will depend largely on individual relationships.

Questions were raised about whether investors would bother with an asset class like FX if collateral management became too complicated, but as one participant pointed out, FX is always somewhere in any trade or cross border activity. If some equity markets have bounced 30-50% in the last quarter, so have

some currencies, so the relative attractiveness may be similar.

While banks insist it is they who will be asking investors for collateral, the principle actually works both ways. Many big institutional investors are now concerned about the stability of the banks they are dealing with, requiring far more information about group balance sheets and support systems.

Ratings agencies used to have a major role in counterparty risk management. Any bank with a certain rating was considered a reasonable risk, but investors now need to be prepared for default from these major institutions as well.

Prime brokers

The relationships banks and asset managers have with their prime brokers has also changed over the last few months. Banks are struggling with their role as proxy or custodian for their clients. There has also been a flight to quality, with banks cutting their list of counterparties.

Prime brokers, meanwhile, have moved away from

their traditional role which tapped the liquidity of one bank using the credit of another. That doesn't work so well anymore, as they can't utilise their securities to leverage themselves.

The core problem is that a prime broker concentrates credit risk, which is exactly what investors have been trying to avoid over the past year. But if collateral management can be managed effectively to remove credit risk, leaving net settlement and CSAs to take care of the P&L, the role of the prime broker re-emerges, as long as liquidity is maintained.

"I think the prime broker arrangement can expand from being a credit pooling arrangement to being a collateral pooling arrangement, and then I think it can really work," said one guest at the Forum.

At the moment the market is in an interim stage between the initial flight to quality and a new scenario, where investors need to be very sure about the quality of a prime broker, because of the concentrated risk. As returns are lower, there are not enough fees to support layers of intermediaries. Investors will have to understand the cost of doing business with multiple counterparties, each of which needs separate due diligence, ISDA agreements and collateral arrangements.

How long before a new order in collateral management emerges? Looking at the evolution of similar structures in recent years, the Forum guests felt that commercial providers may be able to step in after 12 months, while the central banks, pushed by the regulators, might take five or 10 years.

Alternative platforms

Alternative trading platforms proliferated as markets rose, but, perhaps predictably, have struggled as markets have fallen, suffering the consequences of lower volumes and smaller trade sizes. No single electronic trading platform reached critical mass before the credit crisis developed, and if issues such as collateral management develop, managers will not want to proliferate costs with multiple trading venues.

Banks have invested heavily in their proprietary trading platforms, which they will continue to support. An interesting question is how they will push these platforms out into emerging markets. "Trading is all about relationships and it doesn't matter how good these toys are, as I call them affectionately, they were all shut down for a period of time, no-one wanted to use them. You need to know who the counterparty is, so anonymity is not a great draw at the moment," notes one participant.

ECN innovations have often benefited clients, but the systems were all designed for a different market – for an ever-expanding liquidity, and lower transaction cost type of market, which is no longer there. If the market does not regain its pre-crisis shape, electronic trading networks will have to be re-thought, especially banks' proprietary models where liquidity gets sucked out of the market fast if they're left open.

Many players feel electronic platforms had already reached the limit of their utility. Systems like FXall, which were strong in the corporate market, were no longer growing and business was shifting to FXConnect, with its global links. Those that have survived will have to adapt to a different environment where

OUTLOOK : MORE REGULATION, FURTHER FALLS, BUT NEW OPPORTUNITIES

The Forum participants widely expect further currency volatility, the opposite of 2006/7 when there was a period of enforced low volatility. All anticipate the rise of new currencies, and are watching how China and other countries will act if the dollar continues to weaken, with the associated risk of further major economic fallout.

There is clearly appetite among governments for a step change in regulation, a feeling that they have to be seen to be doing something, quickly and drastically. Government intervention can be a power for good when it eliminates bad practice, and there have clearly been many cases of that. But when government regulators get involved in sectors and issues they don't understand they are creating more problems than they are solving.

The fear of politically driven regulation is a recurring theme. Some markets are already beginning to feel the impact of government interventions, with a re-writing of established rules and regulations, and that makes for a dangerous environment for any investor.

However, at least one participant feels that intervention now might stave off worse later. If a rapid recovery leads to complacency, it could mean further restrictions and another downturn and loss of confidence. "There's a feeling that 'well perhaps it wasn't so bad, perhaps we did weather it, perhaps it does work after all, maybe we'll just leave it as it is,' which is storing up trouble," commented one guest.

What investors, and product providers need is a regulator and government that understands the business it is supervising, and is motivated by the desire for increased efficiency and prosperity, rather than a political agenda. They also note also a creeping note of regulatory competitiveness, which will lead to regulatory arbitrage. Evidently, the reason there has been no endorsement of a global 'super regulator', is that no country will back the body, unless it is that body.

With all the problems we should not lose sight of the tremendous opportunities. We see a desynchronised growth story with the range of new currencies coming through. Some countries will do very well and others will not manage it, and end up with inflation or deflation. Within the sector the challenges are managing fees and finding the right talent for your business. The FX markets are not going to go away but actually steering a business through them, in terms of operational development, through collateral management and documentation processes, is going to be a real challenge. Clients are demanding a whole lot more, you can't grow the business if you don't have the support structures.



they are complementary to, but not a substitute for, the main markets.

The challenge will be for these systems to develop the technology to deal with new conditions, broadening their reach across markets and asset classes, and leveraging their undoubted facility to help banks cross sell across their client base. ECNs also allow greater transparency and client interaction, allowing investors to monitor, and managers to report more quickly and accurately, in customised formats. There is far more interest now from clients in “what goes on underneath the bonnet” than in the past.

Some participants at the Forum felt the FX markets have a long way to go to catch up with the equity markets in terms of interaction through exchanges. “There are a lot of different types of foreign exchange business out there, from institutional to retail and also liability-driven flows,” noted one guest.

High net worth clients are a relatively unexplored segment of the market. Some players see a blurring of the boundaries between institutional and retail products, where each supports the other. The Luxembourg SICAVs are the classic example, where a master feeder fund may have thousands of shareholders who collectively represent institutional-type buying power and flows. The multiple share class structure of these funds gives them considerable scale, especially when currency options are added in.

For more exotic currencies, these structures can help develop liquidity. “The interesting thing is it’s the polar opposite of what we’ve known in the foreign exchange markets for the last 50 years, where the investment has flowed into the curious (exotic) currencies. You also have roundtrips where the investor wants to go through an offshore vehicle to invest back into his country.

Learning from history

An interesting point of discussion was that participants no longer place such high store on technical data as before. For years, chartists dominated FX

analysis, but many traders have lost confidence in them. Some markets, such as the yen trades, still have a heavy technical bias, but interpretation has become more complex.

“There’s a lot more people drawing on past history, looking up what happened to the UK in ‘92 when sterling came out of the ERM, and trying to apply those lessons today. People study price action but I don’t think it’s the same simplistic approach that perhaps applied before.”

“You’re looking at, for example, something in the price action or events in 1987 that explain what happened in the last 18 months. Or something in 1998 and the run up to LTCM that carries strong echoes of what happened in 2007 or in 2008. That’s a far more appropriate approach and it’s a sign of a market growing up. One of our jobs, whatever we’re doing, is to understand the history of where we are, and I think that’s the shift we’re seeing.”

Besides, the “small science” of chartists is now highly accessible, which also means it has lost its edge. The numbers provide more of a retrospective explanation than a drive for investment strategy and the strategy moves from self-fulfilling to self-defeating. More in demand is deeper social, economic and historical analysis, especially in the “curious” (exotic) markets, where rapid shifts in government policy can upset charts very easily.

Regulatory changes

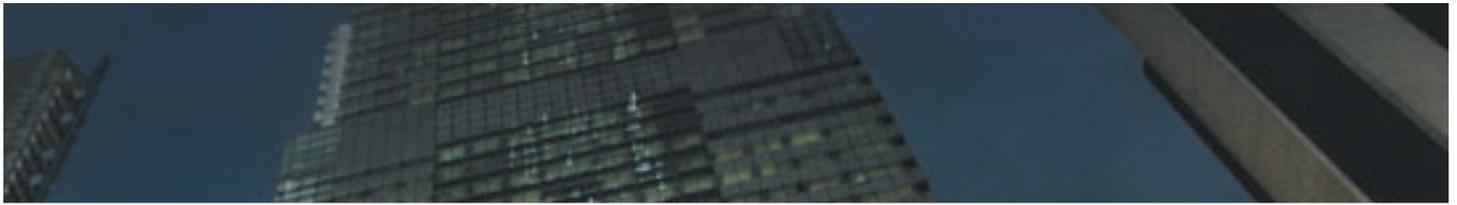
If regulators feel they have to be seen to be acting quickly, the market can expect swift changes. That appears to be the driving force behind the new EU Directive on alternative investments, which appears to have been rushed through without reference to some previously conducted, and highly regarded, consultative work. There is strong political momentum from G7 and G20 member nations for this kind of reaction.

Many market players feel that the financial industry is being targeted by politicians and regulators, even though the foreign exchange sector itself had no part of the recent crisis, and remains stable and intact despite it. Some protection may come from the sheer scale of FX markets, where, if one jurisdiction starts to become over regulated, flows just move to another that is less so.

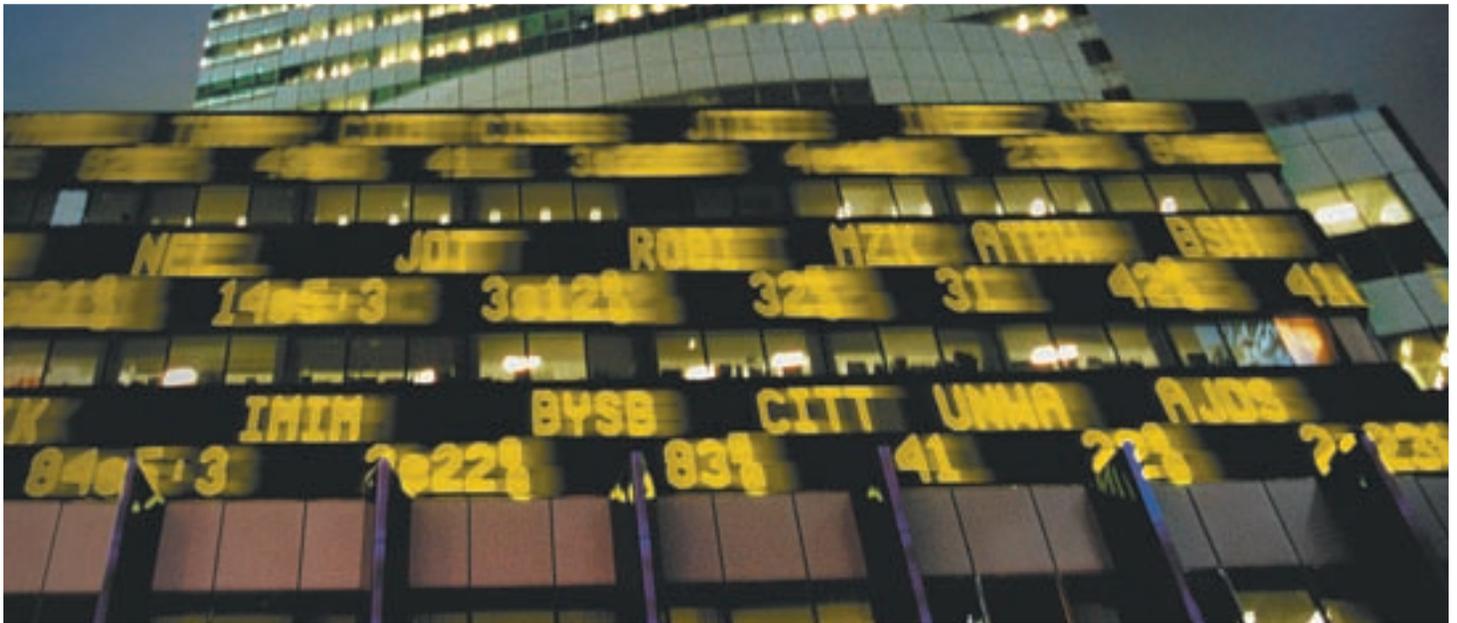
“A government can decide to regulate its banks that it licences, or its stock market, but the FX market is a global market and if you’re regulated in London they’re just going to stop trading in London and they’ll trade somewhere else. The only way the FX market gets regulated is if all the major governments get together with a coordinated plan.

That’s been impossible in the past, but there are clearly moves to change that, on the basis that banks are global institutions, and to move into previously unregulated areas, and new jurisdictions.

The involvement of retail investors in the FX markets, previously strictly a domain for institutions, has given regulators the lever they need to step in, to protect smaller players. Japan has a strong retail investor base, and so has China and Hong Kong, but action has moved from the FX markets to CFDs for these investors. ■



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