

# FX e-commerce – shaping the future of the FX business environment

*The electronic foreign exchange (eFX) market has been growing at an exponential rate, even during these uncertain times. This surge in use can be attributed to the advantages eFX has over the traditional methods of FX trading. In this article, Absa Capital explains the benefits of eFX trading and how improvements will drive the South African eFX market towards global standards and best practice*

The foreign exchange market is known to be the largest and most liquid financial market in the world.

According to the Bank for International Settlements (BIS), the average daily turnover in the global foreign exchange markets is approximately \$3.98 trillion and recent estimates project \$4.5 trillion by 2010. The BIS attributes this growth in turnover to financial institutions.

Moreover, an increasing proportion of the overall foreign exchange volume is being traded through electronic platforms – both in the interbank market as well as between banks and clients – by large global investors and non-bank market participants, as well as by electronic algorithmic trading strategies.

Despite finding ourselves in the midst of a global financial crisis, we continue to see a remarkable transformation in the market, in terms of by whom and how foreign exchange is being executed.

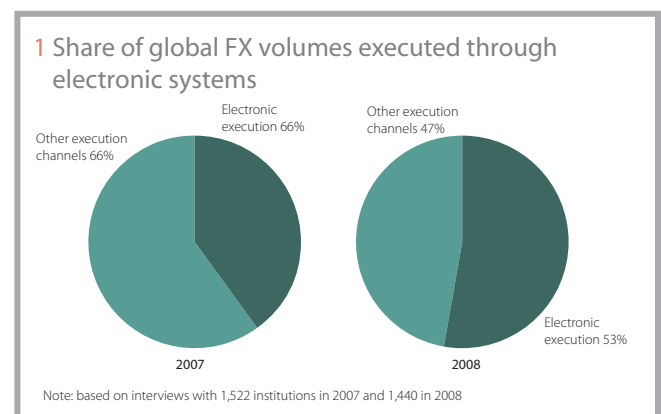
The key players in the electronic foreign exchange (eFX) market include central banks, banks, hedge funds, investment managers, commodities trading advisers, brokers, retail aggregators and corporations.

A recent Greenwich Associates survey shows that the growth in eFX last year far outpaced the expansion of foreign exchange trading as a whole – with a 37% surge in electronic trading versus a 13% increase year-on-year in total foreign exchange trading volume. Much of this has to do with the advantages of a short-term investment horizon and the emergence of foreign exchange as an asset class for portfolio diversification, as well as the emergence of algorithmic strategies adopted by hedge funds and real-money accounts.

As a result, the proportion of global foreign exchange trading volume executed through electronic channels increased to 53% in 2008, from 44% the previous year.

## The start of eFX trading

The start of eFX trading would have to point to the introduction of Reuters Dealing and EBS in the early 1990s. Although the take-up of interbank eFX tools was at first relatively slow, by the late 1990s these platforms came to dominate the interbank trading flows. Best estimates now have their combined market share at around



90% of interbank trading in most currency pairs.

Through natural progression, banks started developing their own proprietary platforms to provide eFX pricing to all of their own clients. Much like in the interbank market, clients' initial acceptance of the e-commerce platforms was relatively slow.

Banks, however, continued to develop these platforms to provide clients with powerful execution tools. The advances in technology enhanced the ability of banks to provide clients with close to zero latency in pricing, which not only reduced the risk for banks to publish pricing on the electronic channel, but also increased the level of confidence that clients had in executing via these channels.

The advances in pricing capabilities on these platforms set the framework for the next generation of trading platforms, both from banks and third-party providers.

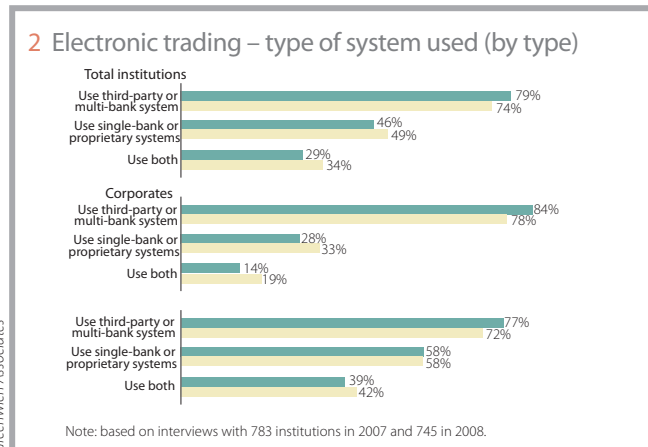
Electronic trading tools then moved towards offering foreign exchange algorithmic execution, direct-market access, anonymous execution venues and sophisticated foreign exchange order and order-matching tools.

Foreign exchange options, certain structured products, as well as cross-asset functionality, are all actively used by clients in the global markets.

The market has now added robust research and analytical tools, charting and automated post-trade processes. These all

supplement the execution functionality available and, along with prime services, ensure that there are a variety of solutions accessible to clients for their foreign exchange requirements.

All of these improvements in terms of how banks were able to manage and distribute their foreign exchange services led to the number of execution venues gradually increasing. Banks not only offered liquidity on their proprietary platforms but also directly into clients' in-house technology systems via application programming interfaces, messaging systems (Bloomberg and Reuters), electronic communication networks, retail platforms and multibank portals. Figure 2 shows the type of system used for electronic trading.



**Managing risk**

The increase in volumes through electronic channels has also advanced the evolution of how banks manage risk. Banks developed auto-trading technology to hedge all of the foreign exchange flow received through the variety of available electronic channels. Algorithms designed to auto-hedge this flow have provided banks with powerful capabilities to manage this risk.

The South African foreign exchange market is a very well-established and developed market, with the rand being one of the most actively traded currencies within the emerging markets. As the rand played a more significant role in global portfolios, banks have had to ensure they are able to deal not only with offshore banks but also with hedge funds and asset managers.

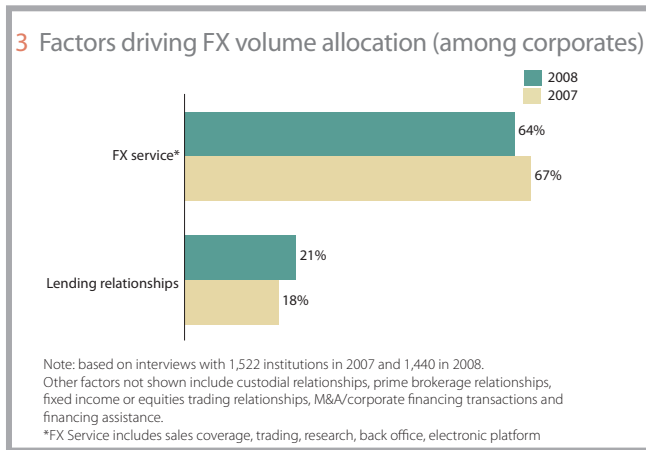
Electronic delivery facilitates this through providing liquidity into execution venues and enhances how global players interact with the local market.

While the electronic interbank market in South Africa is reasonably mature, the client eFX market has been very slow to develop. A few international and local banks have offered foreign exchange platforms and have seen reasonable levels of market penetration. Some of the main reasons for the slow uptake on eFX platforms would be poor technological infrastructure, platform sophistication, client education and no real demand from the corporate segment, with their preference being traditional means of foreign exchange coverage.

As the South African technology infrastructure improves, Absa Capital has seen demand for execution platforms increasing due to clients seeking improved execution, work flow efficiency and increased focus on audit and control processes.

The benefits that increased eFX brings to local clients include:

- real-time access to bank liquidity and pricing;
- confidentiality when executing;
- low processing costs;



- better control over when and how to execute; and
- efficiencies in back- and middle-office functions.

While the global eFX penetration numbers are impressive and indicate to the market key trends in how all client segments execute their foreign exchange, as we look towards the South African market, it is important to understand not only clients' behaviour and requirements but also how other factors like exchange control and poor technological infrastructure impact the ability to offer e-commerce solutions.

Even though the governance around how the local market executes foreign exchange differs greatly to the global markets, the solutions available to clients will centre around how to optimise work flows, enhance control around execution and ensure that the e-commerce offering is a value-added proposition for clients across all segments.

Analysis (as shown in figure 3) of the factors driving foreign exchange volume allocation among corporates clearly shows how foreign exchange service is far more important than lending relationships. Foreign exchange service can be defined as sales coverage, trading, research, back-office and e-commerce solutions.

The impact of eFX on the South African market will not only provide clients with an efficient means of executing foreign exchange, but will also see an increase in volumes traded with local pricing being delivered into global execution channels. Although the predominant increase in volumes will be driven by financial institutions, as the market recovers, electronic channels will provide an efficient base for execution for all market participants. Absa Capital, through its affiliation with Barclays Capital will be leveraging the multi-award winning Barx eFX platform as it drives its local e-commerce initiatives.

The improvements in local banks' eFX offerings, not only to corporate clients but also to retail investors, will all be part of driving the South African market forward towards the global standard and best practice.

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