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SPEECH

# Developments in the FX Market: New Opportunities, Risks, and Responsibilities

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### Introduction

Good morning ladies and gentlemen. It is my pleasure to be here—I want to thank the organizers for inviting me to speak at this conference. Most of us spend a lot of time thinking about recent market moves—which by their nature capture our attention: which way are exchange rates moving in the short run? How will the bond market react to some piece of incoming data? We spend less time thinking about the broader trends that affect the structure of our business. This conference provides a welcome and important forum to reflect on a wide range of relevant topics.

My goal this morning is to leave you with four messages that I hope fit with the agenda as a whole.

- First, technological change is driving a period of rapid transition in the FX market, which continues to evolve in dynamic ways.
- Second, in this environment of rapid change, fundamental relationships between all participants in the market are being tested and transformed, with significant implications for market structure.
- Third, new relationships, new activities, and new opportunities come hand in hand with fresh challenges and, importantly, new risks. These risks need to be properly identified, measured, and managed to ensure the continued smooth functioning of the market.
- And fourth, a constructive dialogue between the public and private sectors is even more critical in times of change, such as the one we are in now.

### Recent Developments in FX Market Structure and Condition

In my view, the foreign exchange market continues to be characterized by remarkable innovation and constant change. If one goes back only 15 years ago, the very nature of how risk is intermediated has changed. Paper-based systems have been supplanted by automated ones. Platforms like EBS have transformed the interbank market, while greater transparency has leveled the playing field to some degree among different groups of market participants. Bid-offer spreads have narrowed substantially and the market has become more efficient. Nevertheless, those dealers that have been able to adapt to technological change and provide value-added services to clients are reporting record profits.

This intense competition among financial institutions has heightened consolidation pressures over the last decade. Just to cite a statistic or two, this year's Euromoney poll indicates that market share remains heavily concentrated, with roughly 45 percent of the total market in the hands of a small number of players. Another reflection of this consolidation trend can be seen in the number of dealers participating in our tri-ennial survey of FX turnover. At its peak, 180 firms responded to our survey of the U.S. market in 1992. That number was down to 84 in 2001 and, I expect, will be lower still in 2004 when we next conduct the survey.

Let me highlight two other important developments in the past few years.

- First, the introduction of CLS last year marked a major milestone in the private sector's effort to minimize FX settlement risk, with gross trades settled via CLS now approaching $1 trillion per day. If use of CLS's 3rd party services takes off, the implication might be to further concentrate correspondent banking relationships and contribute to additional industry consolidation.
- Second, single bank and multi-bank electronic trading portals appear to be getting more traction. To be sure, most client trading is still conducted through more traditional means, but surveys suggest that a rapidly growing share of client trades are being completed through these portals. This makes sense from both an economic and efficiency perspective. The conclusion is inescapable: more trades will be conducted through electronic means in the future. The only question is how fast the transition takes.

These technological advances have also facilitated the introduction and proliferation of new products such as prime brokerage and

white labeling.

Prime brokerage and white labeling have the potential to affect the structure and functioning of the FX markets in profound ways. These developments are still relatively nascent. However, if they continue to gain ground and expand, we could look back at this period as a major milestone in the marketplace.

In my view, these products are changing the very nature of relationships among FX market participants. When we think of a typical FX trade, the dealer provides the client with liquidity by taking on a position and increasing its market risk. The dealer also assumes that client's credit risk, both for settlement and for replacement risk, if the client fails before settlement. Those arrangements are well understood by all market participants. But prime brokerage and white labeling services challenge and, in fact, unbundle and repackage those arrangements. Indeed, at a broader level, what were counterparties now become clients and competitors become customers. Meanwhile, the provision of liquidity and the provision of credit are evolving into two distinct services.

Let me turn first to prime brokerage, which allows clients to source liquidity from a variety of banks, while maintaining a credit relationship and placing collateral with only a single entity. This product emerged as an innovative response to an increasingly competitive landscape and can impart benefits to all involved.

- Clients benefit from improved liquidity and more competitive pricing. Their trading universe expands beyond the handful of banks with whom collateral has been placed. A client's operational and settlement risks may also be minimized, as prime brokerage streamlines back office operations.
- The prime broker benefits from the establishment of a fee-based revenue stream in the context of an expanding customer base. The service enables the prime broker to leverage not only its balance sheet, but also both its electronic trading platform and back office functions.
- Other banks may gain as well, enjoying an increase in volume without taking on credit risk of entities with whom they have less familiarity.

Similarly, white labeling, a product that allows the "outsourcing" of FX pricing to large liquidity providers, can create mutually beneficial relationships between firms that had previously been competitors.

- With white labeling, smaller niche firms offer their clients a broader array of FX services, without the costs of independently developing the capacity to offer those services. The white label service provider typically supplies the smaller firm with technology for FX trading that can be re-branded. As a result, the smaller firm can enhance its client relationships without substantially increasing infrastructure costs. It also retains important customer service and credit relationships, while FX pricing and risk management are outsourced to the white label service provider.
- The liquidity provider in a white labeling arrangement benefits from the development of a fee-based revenue stream. The creation of additional distribution channels also potentially results in increased deal volume. In a business with ongoing pressures on margins, this greater volume leverages investments in technology and infrastructure for greater profitability.

**Risks – Both Old and New**

Of course, these aspects of prime brokerage and white labeling receive the greatest attention from market participants. Understandably, it is tempting to focus primarily on the benefits associated with these new products. However, even as they offer new opportunities, these services also involve new risks – risks that must be appropriately identified, priced, and managed. In an evolving global market, successful managers will respond to changing business conditions by constantly re-evaluating the assumptions underlying their risk management philosophies and practices.

**Credit Risk**

One of the most important consequences of the prime brokerage product is the redefinition of credit relationships and the rellocation of credit risk. While the client is able to trade with a variety of counterparties, the counterparty "gives up" that trade to the prime broker. When the prime broker accepts the credit risk for both the client and counterparty bank, there clearly is a greater concentration of credit risk and heightened pressures to manage that credit risk appropriately.

Credit risk in this new environment can become compounded by the active role played by higher risk entities. Prime brokerage was originally developed to appeal to more speculative clients, such as hedge funds and CTAs, precisely because of their limited access to higher quality counterparties. As we move down the credit spectrum, it is important to question whether credit risk is being priced appropriately. In an increasingly competitive and crowded field, fees can be pressured lower amid firms' attempts to generate new customer business. While declining prices may be a logical evolution for a new product, fees should accurately reflect the credit risk involved in the transaction – they should not be a loss leader to attract other businesses.

**Liquidity and Market Risk**

These innovations also redistribute liquidity and market risk. If white labeling arrangements continue to expand, one can easily imagine a scenario where liquidity becomes concentrated in the hands of fewer and fewer firms. And recall that even as we speak almost half of market activity is dominated by a handful of institutions. The full implications of such a scenario are difficult to decipher. This market has always been intensely competitive and transparent. Whether these basic tenets might be challenged as the result of these new services is probably unknowable, but certainly worth thinking about.

**Other Risks**

In some ways, these issues are barely scratching the surface. Many other issues are on the table to be tackled.

Both prime brokerage and white labeling involve new aspects of legal risk.

- A major consideration is "know your customer." How far does a liquidity provider's obligation to "know" the customer extend in some of these arrangements? We may think the answer is obvious, but until the courts have tested these we really don't know.

- In a white labeling arrangement, what is the appropriate level of disclosure? Does the customer need to be told who is the entity actually pricing the trade? This issue can get very complex if the bank is pricing some currencies itself but outsourcing to a white label provider for others.
- And what about documentation issues? It may well be that the market will work better if documentation is standardized for these arrangements, as has been done for other products. Despite recent efforts to standardize prime brokerage documentation there is still an absence of needed consensus on fundamental elements of an agreement. For example, how should a net open position be defined? Can a common approach to "give up" procedures be developed? I could go on with other issues but will not in the interest of time.

When new products are rolled out, the tendency is to take advantage of the narrow competitive window before others follow suit and whittle the margin down. Controls, risk management systems, and the like, typically follow with something of a lag. But the choice to follow this paradigm – and it is a choice – has its risks. New products and services can be subject to misuse, as we were clearly reminded by the situation involving Allied Irish Bank and Allfirst Financial. Senior management needs to ensure that they understand fully the nature and risks of the new products offered by and to their institutions. A complete and comprehensive flow of information is sometimes all that's needed to prevent lapses in risk management. The potential risks of not having appropriate reporting for new business lines are compounded today as financial instruments are far more complex than ever.

Moreover, as innovative services are introduced, the application of fundamental operational controls is key. The separation of front and back offices, clear and distinct reporting lines, effective risk management units, and an independent internal audit function are all essential to minimize the scope for potential operational problems.

As I said earlier, these trends are still relatively nascent, but economic pressures may cause management to consider some of these arrangements – be they the ones I've spoken of or others. I don't think there is a problem now. But there may be a future problem if adequate due diligence is not exercised. The Allfirst case was a warning shot across the bow, reminding us all of what can go wrong.

**Responding to New Risks**

So what does this mean for the industry? New opportunities and risks involve new responsibilities. Responsibilities for the private sector, on both the firm and industry levels, and responsibilities for the public sector as well. All participants have an interest in maintaining robust market practices, free of the abuses that have plagued others.

**Firm**

In a product's infancy, individual firms will naturally focus on extracting value from new business lines. However, re-assessing the shifting risk landscape and ensuring that policies reflect the changing market structure is critical to the long-term success of these products. Moreover, firms must be mindful that a self-regulating market requires each of us to behave as global citizens, recognizing that actions taken on an individual and firm level have broader implications.

**Industry**

On an industry level, the ability of the FX market to regulate itself and promote the dissemination of best practices assumes even greater importance in a rapidly changing environment. When new products fundamentally transform relationships between various market participants, it is important to re-evaluate assumptions underlying business practices. Success on this front also wards off a more serious response from the authorities.

These issues can often effectively be addressed in forums involving many market participants, and can result in the promotion of

best practices for the entire industry and the minimization of the potential for problems down the road. For example, past industry efforts have contributed to greater legal certainty of transactions and established common terms of agreement for a variety of exchange products.

**Public Sector**

Of course, the public sector stands ready to do what it can to facilitate this process. Central bankers are inherently concerned with the promotion of stability and smooth functioning in the marketplace. As a central banker, I strongly encourage the continuous re-assessment of risk management practices we discussed earlier. Any potential deterioration in these standards poses risks not only for individual firms, but also for the broader financial system.

Central banks can play a critical role in promoting and fostering the dissemination of best practices to minimize the risk of market disruptions. Of course, like senior bank management, our first challenge to keep abreast of market developments, no small feat in an environment characterized by such rapid change and innovation. Our need to fully understand the nature and implications of new products highlights the importance of continuous and effective dialogue between the private and public sectors. In this light, opportunities such as this to engage market participants in a discussion of issues takes on heightened importance. Another means of maintaining open communication channels between the public and private sectors has been the establishment of foreign exchange committees. Beyond providing a forum for constructive dialogue, these groups have also proven successful in introducing practical solutions to trade and pratice-related issues.

In conclusion, the FX market is vibrant and dynamic, constantly adjusting to the introduction of new products such as prime brokerage and white labeling. However, it is also an unregulated market that must be mindful of the implications of these products, particularly as they involve a fundamental redistribution of liquidity and realignment of credit relationships.

This transitory environment confers new responsibilities on us all. I encourage you to work together as an industry to address these new challenges responsibly, assured that the public sector stands ready to support your efforts.

Thank you.

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