Forex flows to the East

*Foreign exchange trading has long been concentrated in the financial hubs of London, New York and Tokyo, but as major western markets face up to structural and macro-economic challenges, turnover is beginning to shift to Singapore, Hong Kong and Shanghai. In this article, Mike O'Hara and Joel Clark of The Realization Group discuss this with **Jon Vollemaere** of R5FX, **Matthew Lempriere** of Telstra, **Julie Nicolas** of The FX Hive, and **James Maudslay** of Equinix. They also examine the importance of having the necessary infrastructure and connectivity in place in order to capitalise on the movement of FX activity into Asia.*

Introduction

Foreign exchange is by far the largest, most liquid traded asset class, with $5.1 trillion of currencies changing hands each day, according to latest estimates. But geo-political risks, low interest rates and structural change in the banking sector have put the brakes on the market's seemingly unstoppable growth trajectory and could bring further change in the distribution of FX turnover across products, counterparties and geographies in the years to come.

Among the most significant changes is a potential shift of FX activity into Asia. Financial centres including Tokyo, Hong Kong and Singapore have long boasted a growing FX market, but as traditional western hubs have come under pressure from regulatory and macro-economic forces, both buy-side and sell-side firms are now preparing for an uptick in Asia-based trading and are looking at what they need to do in order to capitalise on this shift.

Global FX Trends

The growth of FX in Asia comes after a period of unprecedented global growth in forex turnover. Driven by globalisation and the increasing need for currency hedging among corporates and financial institutions, as well as the growth of FX as an investment asset class in its own right, average daily turnover grew from $1.2 trillion in April 2001 to nearly $5.4 trillion in April 2013, according to the triennial survey conducted by the Bank for International Settlements (BIS).

But since 2013, growth has clearly slowed and average daily turnover in April 2016 fell for the first time in more than a decade, to $5.1 trillion. Given it sources turnover data for just one month out of every third year, the BIS survey does not necessarily reflect the day-to-day market reality, and turnover in April 2013 was particularly high as a result of volatility in the Japanese yen at that time.

But whatever the true global volume on a month-to-month basis, the growth of the FX market has clearly slowed, and declining turnover data reported by electronic platforms appears to support this trend. A number of factors may be responsible. Most significantly, the banks that have long dominated the provision of FX liquidity have come under growing regulatory pressure in recent years.

While most FX products are less capital intensive than other bilaterally traded asset classes, banks have less balance sheet capacity available to make prices and hold risk for their clients. Non-bank liquidity providers are gradually stepping up to plug the gap, but this structural transition appears to be taking its toll on turnover.

Macro-economic factors may also be playing their part. Slower-than-expected economic growth and a widespread convergence in monetary policy, with near-zero interest rates in many countries, has reduced volatility in major currency pairs. Aside from big risk events such as the Swiss National Bank's decision to remove its currency floor in January 2015 and the Brexit vote in June 2016, the value of currencies has in general moved around less than most participants would like. That has reduced investment opportunities and added to the pressure on turnover.

Shift to Asia

In this challenging environment, it is little surprise that Asia has become something of a beacon of hope for foreign exchange traders and investors. With many emerging market currencies in Asia showing strong fundamentals for growth, and some of the region's financial centres taking a more pragmatic approach to regulation, the region offers attractive opportunities for FX practitioners.

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Julie Nicolas, The FX Hive

"FX traders are very excited about the prospects for Asia, and they expect the region to lead the world, particularly as Brexit may reduce London's share of the global market. There is widespread interest on the buy side in what is going on in Asia and how the major centres are preparing to take a leading role in FX," says **Julie Nicolas**, managing director at The FX Hive.

Given its central location and time-zone, as well as the presence of many top-tier banks and financial institutions, London has historically been the world's leading centre for FX trading. The UK held a 40.8% share of global trading in the BIS 2013 survey, but this had already fallen to 37.1% in this year's survey and could well fall further in the years to come as the UK enacts its departure from the European Union.

"London's share of FX is expected to decrease further and many people think it will be difficult for the city to regain ground after Brexit. We should also soon have more clarity on the likely effect of Donald Trump's presidency on international trade," says Nicolas.

Analysis of the reported numbers suggests the shift to Asia has already begun. The combined share of global FX intermediation of Tokyo, Hong Kong and Singapore amounted to 21% in April 2016, up from 15% in 2013, according to the BIS survey. As the US share of FX trading remained virtually unchanged during that period and the UK share fell by nearly 4%, it appears that Asia is already gaining from London's losses – a trend that may continue in the lead-up to the next survey in 2019.

Singapore

All three Asian centres increased their share of FX trading in this year's survey, but perhaps the most significant was Singapore, where average daily turnover grew from $383 billion in 2013 to $517 billion in 2016, giving it a market share of 7.9%, up from 5.7%. With a well-developed financial centre and strong location to capitalise on south-east Asian flows, Singapore is well-positioned to benefit from a further shift in FX trading to the east.

"Singapore has made significant efforts in recent years to attract more electronic trading and it has clearly moved up in the rankings. It remains to be seen whether London's decline is a short-term theme or part of a bigger trend, and also whether the rise of Shanghai as a financial centre could, in time, overtake Hong Kong and Singapore," says **Jon Vollemaere**, chief executive of R5FX, a new trading platform for emerging market currencies.

R5FX went live with London clients for trading of FX non-deliverable forwards, a popular product for accessing emerging market currencies, in the fourth quarter of 2015, and began live trading in Singapore in April 2016. The platform currently operates its matching engine from the Equinix's LD4 data centre.

"We have been asked about opening a matching engine in Singapore, which is very attractive from a business point of view, but from a technology perspective, running two systems needs consideration. I'm also not sure we would want to limit ourselves to Singapore when the balance may shift to Hong Kong or Shanghai in the future," Vollemaere explains.

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Jon Vollemaere, R5FX

Hong Kong and China

The growth of China's economy and the internationalisation of the renminbi is certainly expected to be one of the most transformative trends in foreign exchange in the years to come. Since 2010, the Chinese government has embarked on a steady process of liberalising its currency for international investment, which has sparked significant interest from financial institutions wanting to carve out market share in the new currency.

It is still early days, but China's share of FX trading grew from 0.7% in 2013 to 1.1% in 2016, while renminbi is now the eighth most actively traded currency, with a market share of 4% - up from ninth position in 2013 and 17th in 2010. While Hong Kong has traditionally been the main hub for north Asian FX flows, the rise of China could well see some movement towards Shanghai, as Vollemaere and others predict.

"China is the big prize in FX and Shanghai will definitely see more trading flows as the renminbi becomes more freely tradable", says Vollemaere. "It's already the eighth most traded currency, so imagine its potential", he adds.

Anticipating the growth of its business in Asia and the importance of China, Telstra last year acquired Pacnet, a provider of connectivity, managed services and data centre services. This has strengthened Telstra's network and data centre capabilities across the region and allows it to grow its business in China.

"China is an important and challenging place to be building out technology solutions. There is a whole raft of local regulations we have to understand and adhere to, and through Telstra's joint venture, PBS, we're able to own a cross-provincial IPVPN license in China which provides customers with network and internet data centre services," says **Matthew Lempriere**, global head of the financial services market segment at Telstra located in Hong Kong.

Ecosystems

As infrastructure providers such as Telstra continue to build their capabilities across the region, banks and buy-side firms must also consider how best to exploit the likely growth of Asia-based FX trading. If the decline of London and even New York picks up pace, market participants will need to make sure they have the necessary infrastructure and connectivity in place to capture and retain market share.

Unlike equities, FX is traded bilaterally with no central exchange, although a number of electronic trading platforms like R5FX match buyers and sellers and offer a central source of price discovery. But given the bilateral nature of the FX market, there is perhaps a greater need than in other asset classes for market participants to be located in close proximity to one another.

"In foreign exchange, people tend to congregate in communities or ecosystems within data centres where they can trade with each other. To capitalise on the movement of volume to Asia, institutions would do well to implement infrastructure here so that they are in close proximity to others trading FX in the region," says Telstra's Lempriere.

"Additionally, they would benefit from working with a partner familiar with the region to help them establish and grow their Asian footprint. This could consist of a completely tailored solution or access to services that already exist", Lempriere adds.

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>
> Matthew Lempriere, Telstra

The difficulty for banks is that while they would prefer their own dedicated space within data centres, and typically wouldn't want to share managed services with clients or competitors, many are also struggling with budget constraints and have limited resources to invest in connectivity and infrastructure.

Infrastructure and connectivity

"In today's environment, it's very important for banks to be able to move things off their balance sheet, so anything enabling them to operate in the region via an OpEx model, rather than a CapEx one, is positive", says Lempriere.

"Many banks are also engaged in data centre consolidation projects, but at the same time they do want dedicated infrastructure they can manage themselves. As a leading Asian technology provider, Telstra can provide them with a caged area of a data centre for their racks and equipment, as well as all of the cabling and connectivity to other liquidity providers in the local area," says Lempriere.

Buy-side firms, Lempriere adds, are often happier to use shared infrastructure and managed services to get access to local markets at lower cost. While physically locating infrastructure in Tokyo or Singapore might seem a big move for a small London-centric currency manager, shared services in data centres offer a comparatively quick and easy route to Asian markets.

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> James Maudslay, Equinix

"People naturally need the same level of certainty and service they get in Europe, and once they realise they can cross-connect to their peers and get the same speed of access and security benefits at low cost in the Far East, they are keen to take on capacity in our Asian data centres," says **James Maudslay**, Senior Manager, Financial Services & Insurance at Equinix.

Like the advent of the telephone network, which only took off once it had gained critical mass among households and businesses, Maudslay believes FX turnover will continue to grow in Asian centres as more participants interconnect their infrastructure in the region, fuelling a virtuous circle of growth.

"In other asset classes, the exchange acts as a magnet to draw participants in, but in FX it is really a numbers game. The more people who are physically located in the data centres, or in some way tethered to them, the richer the environment becomes and the more attractive it becomes. We call this the ecosystem effect. In Tokyo, the market is already quite mature, and we expect it to develop fast in other centres," says Maudslay.

Conclusion

With the recent 5% shift in global FX volumes from London to Tokyo, Hong Kong and Singapore, and with Shanghai now pushing hard to become the new Asian financial centre, experts agree that firms trading FX - on both the buy side and the sell side - need to consider how best to capitalise on this trend, particularly from a technology perspective.

"It's clear there is going to be further FX growth in Hong Kong and Singapore", concludes Telstra's Lempriere. "Institutions that want to benefit from this change would do well to implement infrastructure in these centres, so they are in close proximity to others trading FX in the region."

For more information on the companies mentioned in this article, visit:

www.telstraglobal.com
www.equinix.com
www.r5fx.co.uk
www.thehive-network.com

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