



Effects and influences of the opening up to the buy side of EBS and Reuters

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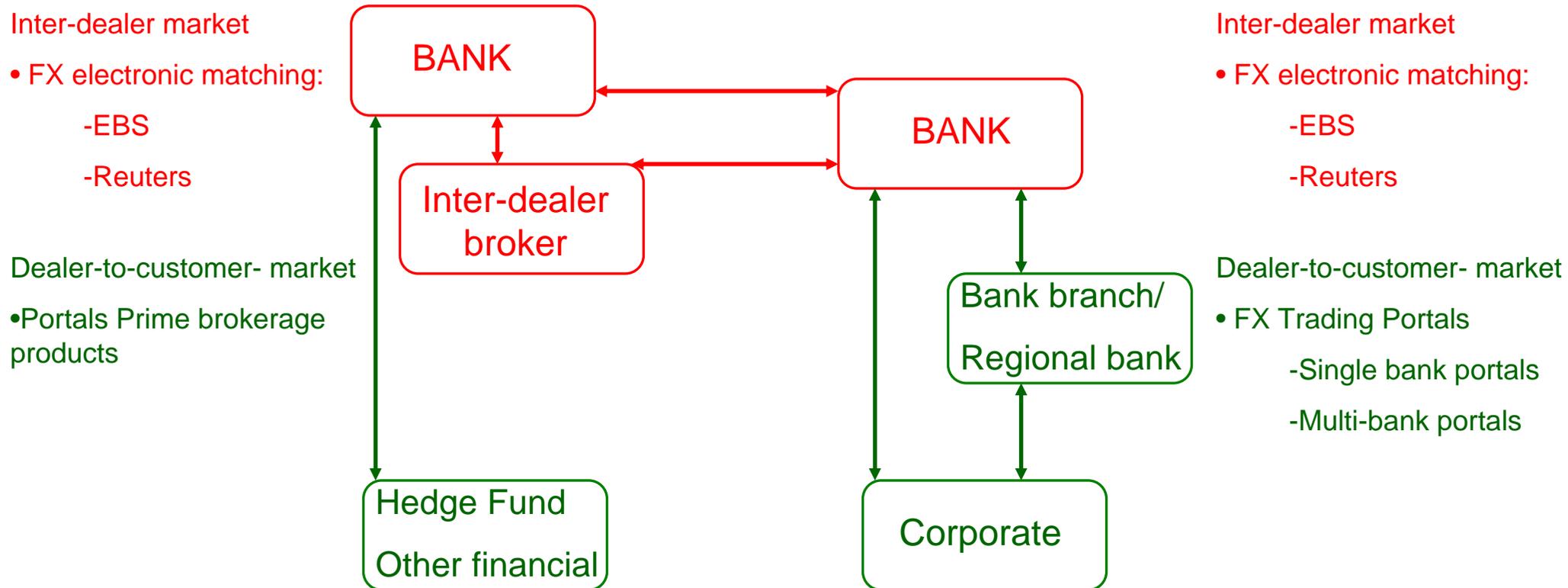
History of the FX market

The FX market

- **1876 to World War I – the gold exchange standard ruled over the international economic system**
 - Under the gold exchange, currencies experienced a new era of stability because they were supported by the price of gold
- **1944 – the Bretton Woods Agreement was founded in order to stabilize and regulate the international Forex market**
 - preventing money from moving across nations and restricting speculation in the world currencies
- **1980's – the onset of computers and technology accelerated the pace of extending the market continuum for cross-border capital movements through time zones. From Telex to telephone to computers.**
- **Transactions in foreign exchange increased intensively from nearly \$70billion a day in the 1980s to an average of \$1.86 trillion a day** (Source: Bloomberg, July 2006)
 - In London trading rose 19% to an average of \$1.03 trillion a day
 - U.S. currency trading increased 21% to an average of \$577 billion a day
 - Currency trading in Singapore rose 17% to an average \$195.1 billion a day

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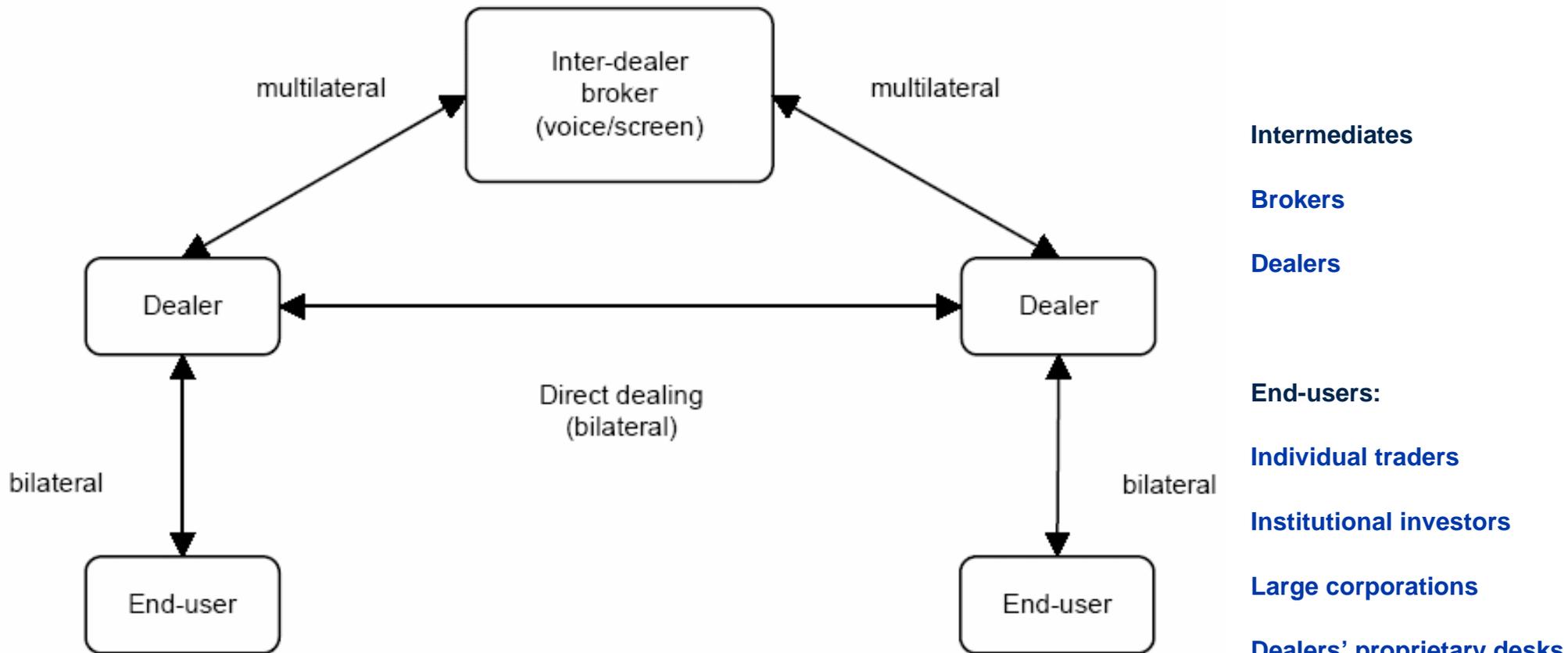
FX: an over-the counter market



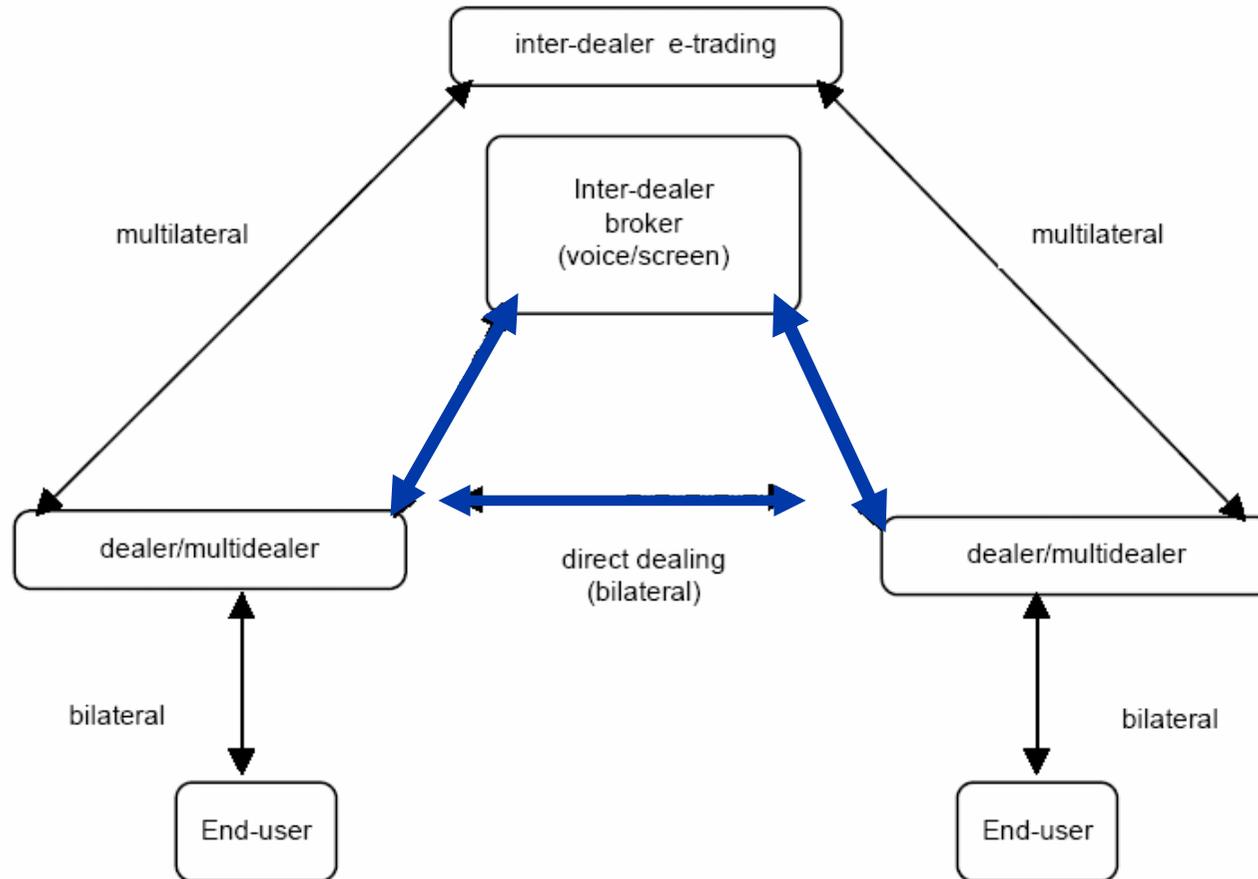
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Cutting intermediaries:

Interaction between participants prior to electronic trading



Interaction between participants after the introduction of electronic trading

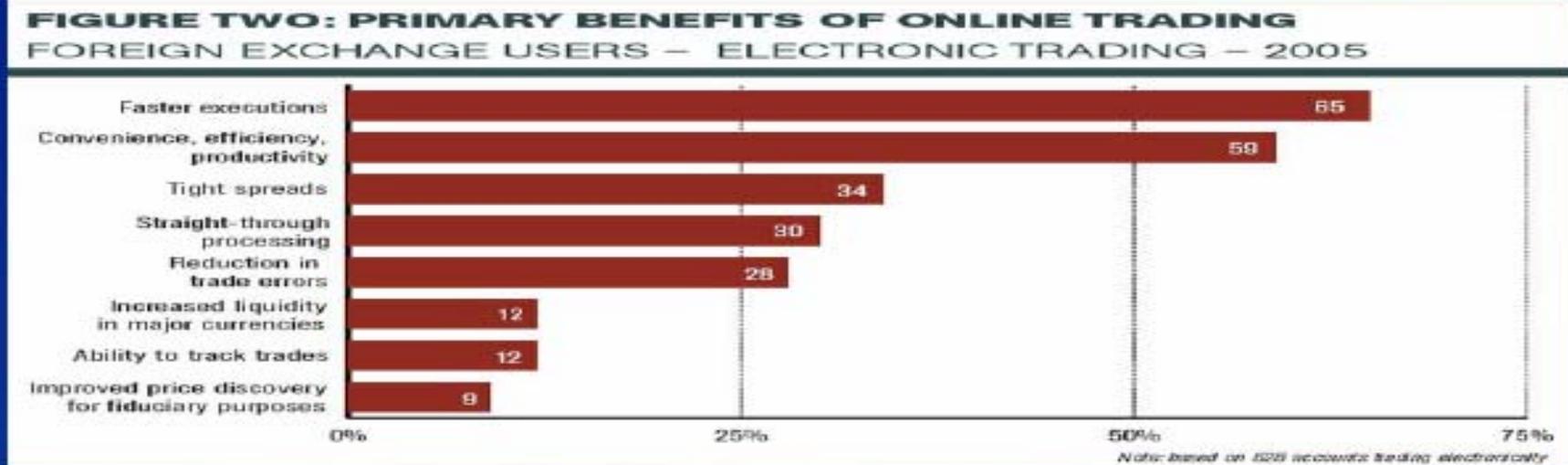
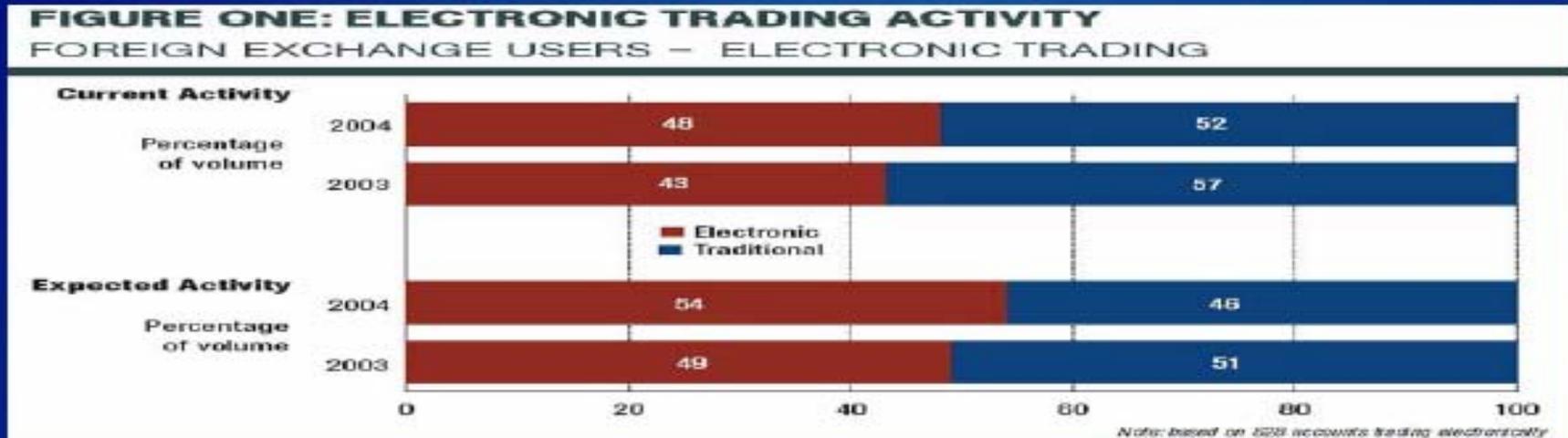


Reduced importance of the direct trading channels and the traditional inter-dealer broker channels?

Current market structure

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Client Adoption / Benefits



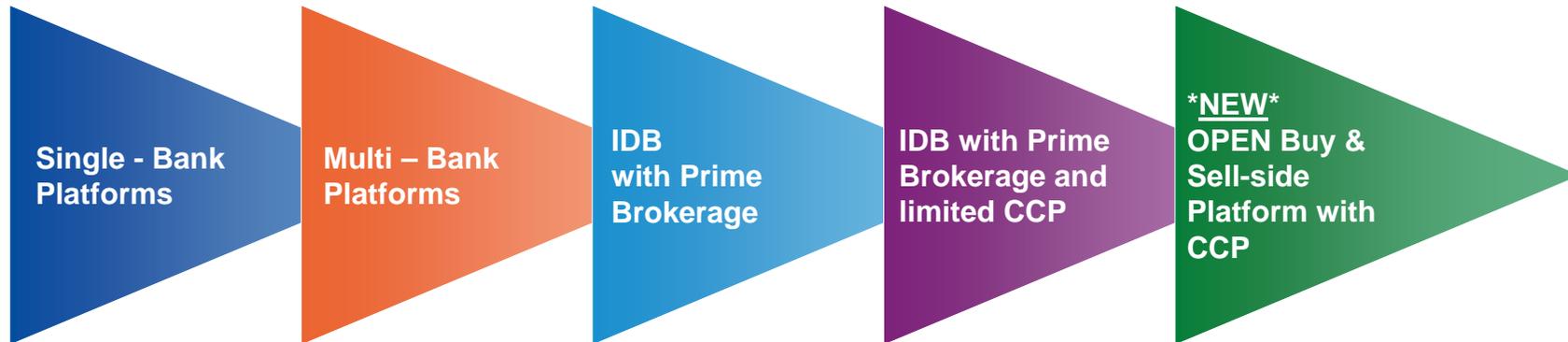
The Stock Exchange vs. an OTC market

- Stock Exchange is a centrally organized marketplace
- Stock markets across Europe are planning to group together:
 - Bourse to merge with Brussels and Amsterdam stock exchange => *Euronex*
 - Norway, Sweden and Denmark are pooling their exchanges
 - London Stock Exchange and Deutsche Boerse => *iX*
 - Plans to link up with New York's hi-tech exchange Nasdaq
=> could pave the way for a unified global stock exchange
- Equity markets are the best known and most widely studied examples of electronic trading
- Bond side can be traded on electronic platforms:
 - Trade Web, Market Access, Bloomberg - BBT and AutoEX System, Reuters - MTFI platform

The FX market (OTC) is living through continuous transitions but can a similar trend be seen as in the Stock Exchange?

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Market Evolution: The market is driving towards a more open trading alternative



- Bilateral customer relationship
- Client relationship / cross-market capability
- Attract additional order flow

- Effective liquidity management
- Manages market growth
- Consolidated market efficiencies

- Service hedge fund flows
- Support for algorithmic models
- Attract additional order flow

- Provide credit intermediation for the credit-challenged inter-bank market
- CCP = Centrally cleared counterparty

Inter-dealer market

- Two strong platforms with complementary currency pair strength
- EBS and Reuters have become very impressive liquidity pools'
- Number of transactions on both systems: steadily rising in recent years with little evidence of significant price-gapping

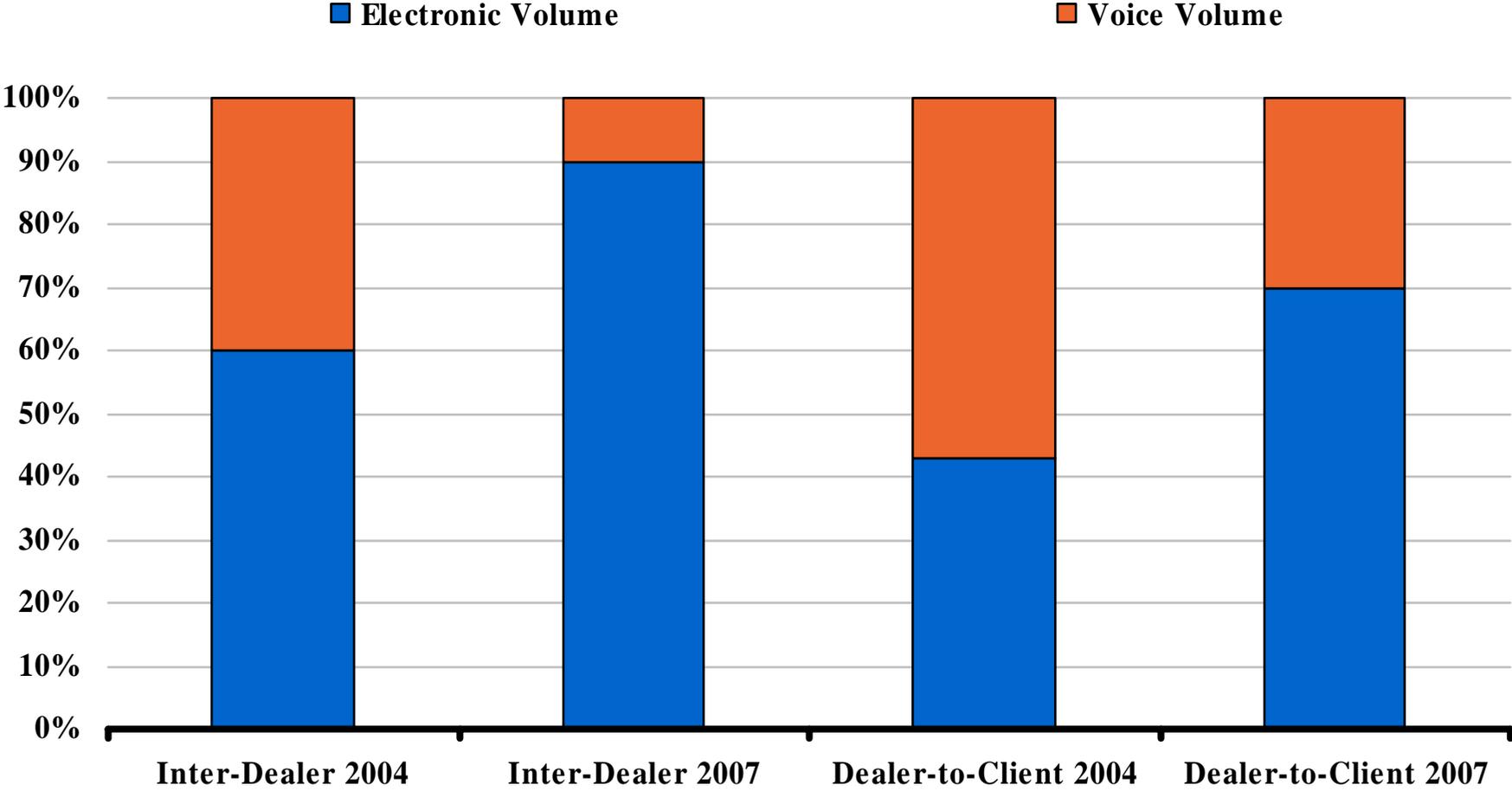
Dealer-to-client market

- A fractured market with specialized platforms
- Targeting a specific type of customer within the buy-side
- Hotspot - serving hedge funds and CTA's
- FX Connect – serving asset managers
- 360 Treasury System - dominated among European corporate treasurers
- LavaFX and eSpeed – strength in equities trading

Is there room for all the existing and new platforms in this market?

How much does the market rely on the robustness of surrounding telecommunications infrastructure?

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Source: BIS, December 2004

Buy-side

- **More interested in trading on electronic FX platforms:**
 - **Speed of execution**
 - **Transparency**
 - **Buy-side customers also are attracted to the electronic platforms by the lower transaction costs**
 - **The audit trail is much easier to follow with electronic platforms**

Sell-side

- **Interbank market is becoming more bifurcated**
 - **Large banks contribute price discovery and liquidity to the electronic platforms**
 - **Small banks act like buy-side customers in the dealer-client platforms**
=> removing liquidity but only nominally providing it

Reuters

- **20 years' experience in the FX and money markets**
- **1996 launched Dealing 3000**
 - **Spot Matching, Forward Matching, Reuters Matching for FX Options**
- **43 key currency pairs in spot and 28 currencies in forwards**
- **19,000 users located in more than 6,000 organisations in 110 countries worldwide**
- **112,000 users in Reuters Treasury community**
- **18,000 Conversational Dealing users**
- **7,000 Dealing Matching users**
- **Revenues of c. £1 billion in 2005 from Reuters Dealing and Treasury information services**

EBS

- **World's leading FX Spot broker**
- **1990 - 12 major international banks agreed to challenge Reuters' threatened monopoly in interbank spot foreign exchange and provide effective competition**
- **September 1993 – EBS Dealing System launched**
- **EBS alone averages some \$90-\$100bn a day and up to 700 trades a minute**
- **2,000 traders on more than 800 dealing floors in + 40 countries**
- **EBS Spot, EBS Prime, EBS Spot Ai, EBS market data**
- **Average of trade per day of**
 - **USD 130 billion in spot foreign exchange transactions**
 - **700,000 oz in gold and 7 million oz in silver**

Ai and PB

Current situation of the Ai and PB systems:

- Prime Brokerage systems:
 - Before the advent of hedge funds services include:
 - Cash lending through margin services and ‘repos’, stock lending and foreign exchange transactions
 - Now most prime brokers:
 - Added more sophisticated services
 - Individual profitability is a matter of speculation
 - EBS Prime
 - Reuters
- Application programme interface technology:
 - EBS Spot Ai
 - Reuters’ Matching-over-internet-protocol

Reuters Prime Broker

- 17% of Reuters volumes from trading
- 10% of the figure from the sell-side
- 90% of the figure from the buy-side

MOIP (Matching-over-internet-protocol)

FX Market Space

- Joint Venture: Reuters and CME
 - Will be a direct competitor to Reuters' and EBS
 - Created its own independent pool of liquidity

FX MarketSpace

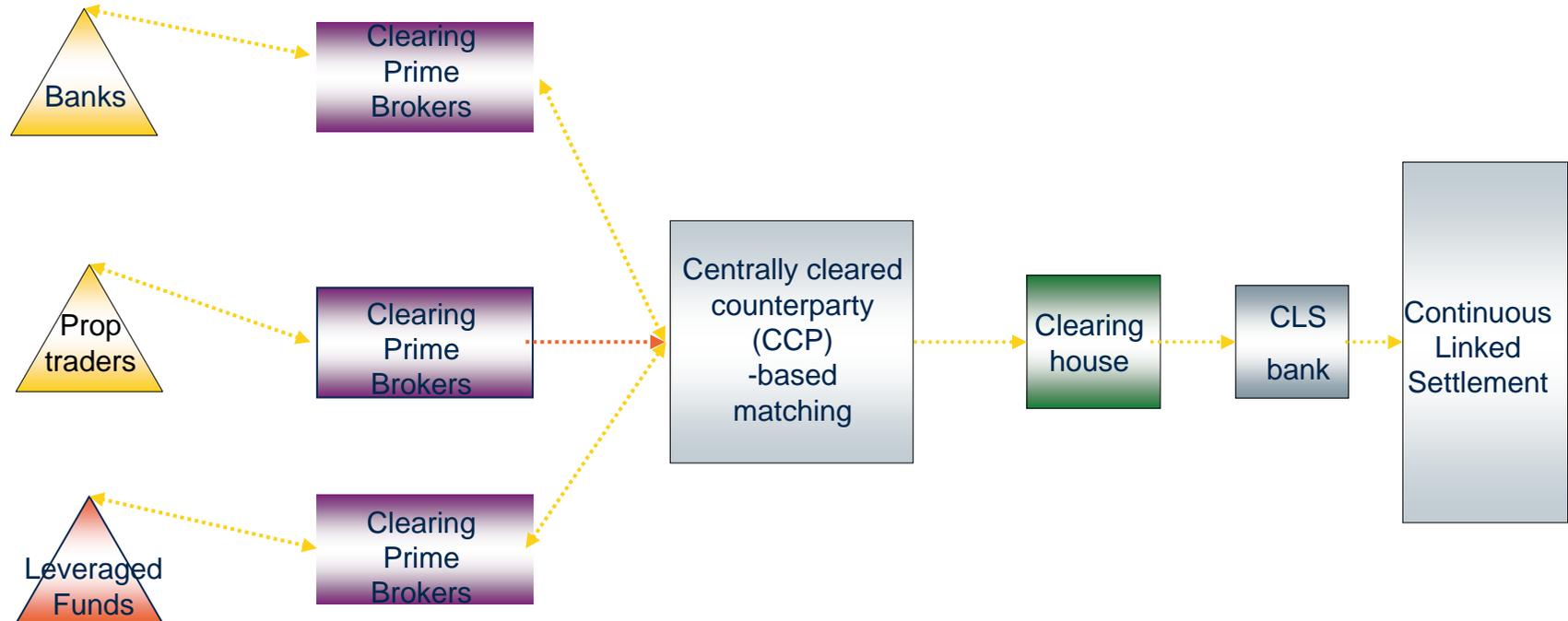
Reuters' value proposition

- Reduced cost of trading
- Reduced risk
- Centralised pool of deep liquidity
- Anonymous, multi-lateral matching
- STP and operational efficiency
- Strongly funded

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The FX MarketSpace value

Access via Reuters GUI or CME GLOBEX API



Buyside / End User

- GUI - Reuters integrated
- API trading – support for algorithmic trading
- CCP – no bi-lateral credit required
- Aggregated liquidity
- Comprehensive STP

Prime Broker/Clearing Member

- Fiduciary responsibility
- Authorise access
- Enforce access rules
- Post collateral with CCP
- Limit & trade admin
- STP – allocations, etc.

Liquidity Providers

- Access to best pricing & aggregated liquidity
- Anonymous trading
- Access to flow
- No credit risk
- Operational cost savings
- Reduce e.trading costs

Clearing House

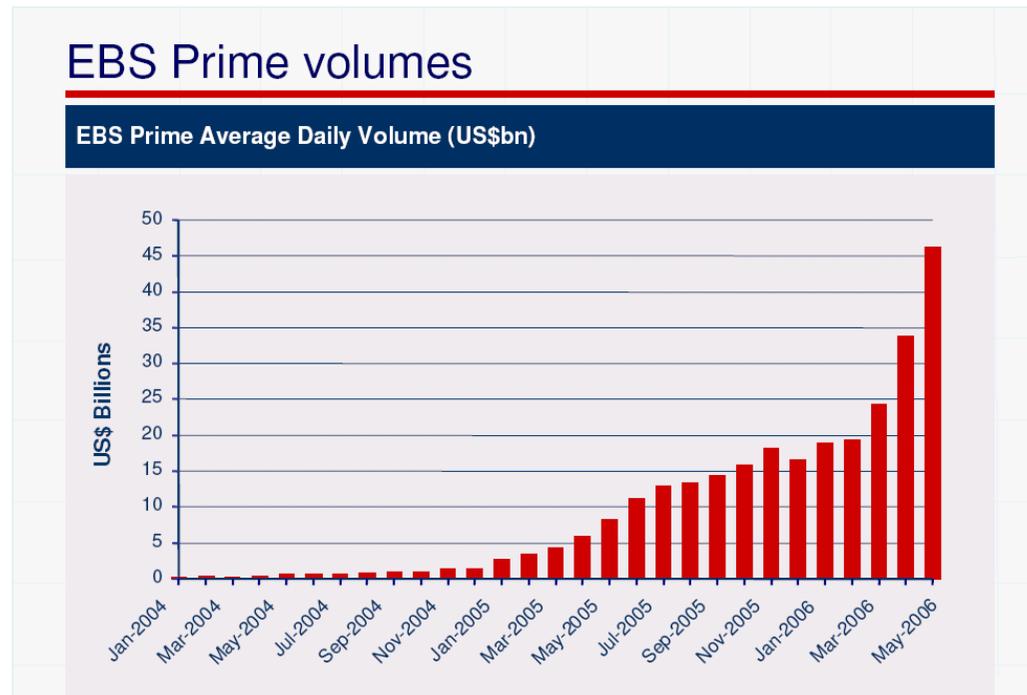
- Multilateral netting
- Collateralised margining
- Net settlement
- Improvement of funds flow
- Facilitates increased trading
- Real-time deal confirmation

CLS

- Settlement risk elimination
- Operational efficiencies

EBS Prime

- 149 users now live
 - 37 non-bank customers including hedge funds
 - 112 bank customers

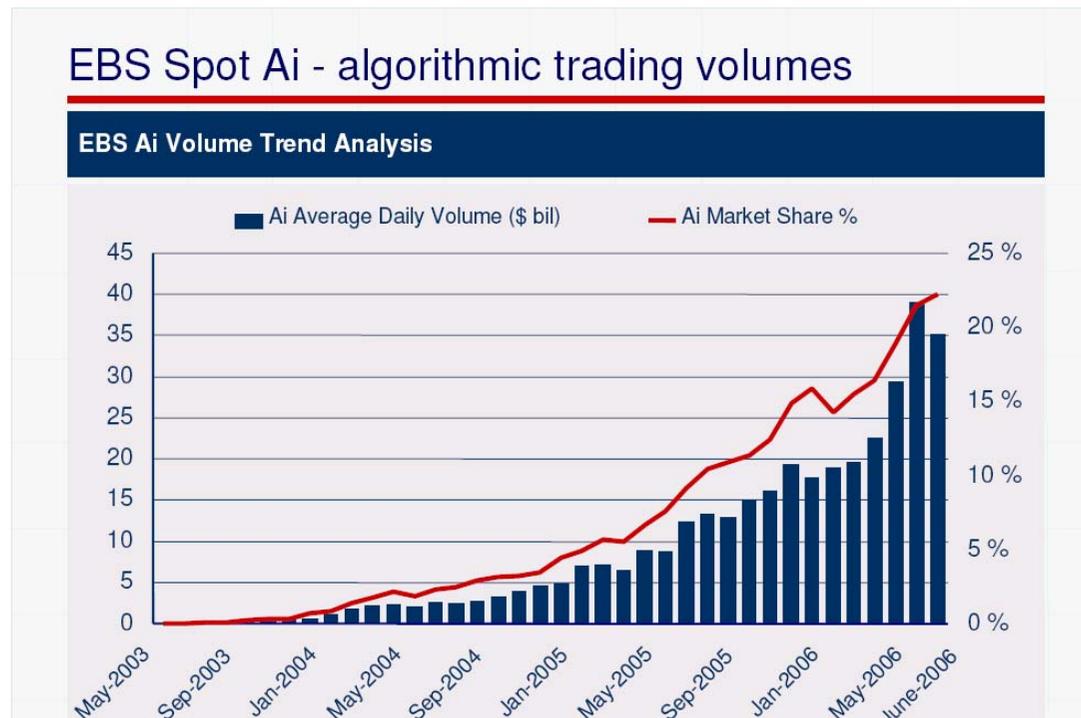


EBS Prime: Benefits for the Customer

- Same liquidity available to EBS' top tier bank
- See and trade on prices previously unavailable due to limited bilateral credit
- Access to tighter prices and greater depth of liquidity from the world's leading market making banks
- Continuous price stream of more competitive prices
- Increased probability of execution of orders (deal on your bid/offer)
- Maintain the relationship between banks and their clients

EBS Spot Ai

- API or 'black-box' FX trading
- Average daily volumes – USD 30 billion
- 20% of EBS volumes from API-based trading



Revenue

- **Services such as cash lending through margin services and 'repos', stock lending and foreign exchange transactions remain the core profitable services to the banks**
- **Customers contract directly with EBS Prime banks**
=> pay a fee to their EBS Prime bank
(typically in the form of a spread added to the dealt price on the EBS Prime Customer's deal ticket)
- **Customers pay a standard EBS Spot transaction brokerage fee to EBS**

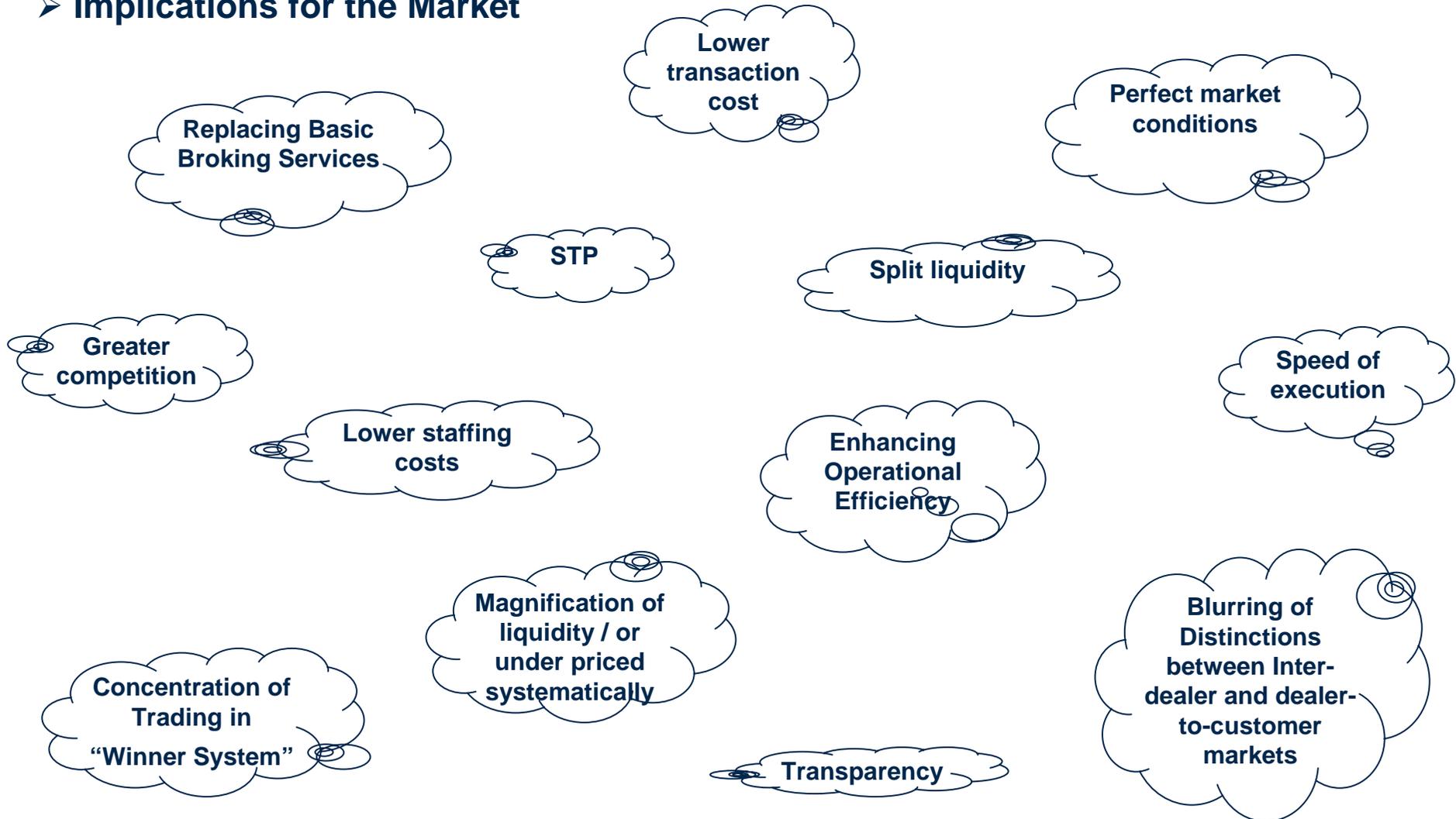
Prediction for the Prime Brokerage Units of Investment Banks in 2006

- Rise in revenue for the PB Units of the major European and US Investment Banks
- Reasons for rise:
 - Prime brokerage compete to offer additional services
 - Prime brokerage services to hedge funds can be seen as the catalyst to capturing their transaction flow

Market Risk

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➤ Implications for the Market



Evaluating the market development

- **Liquidity**
 - Will it be possible to trade in size on demand without moving the price against the price maker?
- **Settlement risk**
 - How high will be the Herstatt risk?
- **Systems/operations**
 - How to react to upcoming errors such as non-matching trade confirmation?
- **Credit intermediation**
 - Will the credit risk arise?
- **CLS**
 - Market-standard for FX settlement between major banks
 - 04/2006: 300,000 instructions a day in 15 currencies (98% of global FX trading)
 - Average daily value exceeding US\$2.5 trillion
 - Will there be more exchange styles?

Profitability models

Source of revenue

- Proprietary trading
- Spread (for all products such as vanilla and exotic products, derivatives, etc.)
- Prime Broking fees
- Latency arbitrage

What might be the future for the eFX market?

Proprietary trading

- Banks making a profit for itself when trading its own money
- Majority of trading profits comes from bond and commodity
- Proprietary traders make big profits versus often equally high losses

Spread

- Structured in two different ways ('cash' versus 'volume')
 - ⇒ Which one is more profitable?
 - ⇒ Will the transparency 'destroy' the profitability?

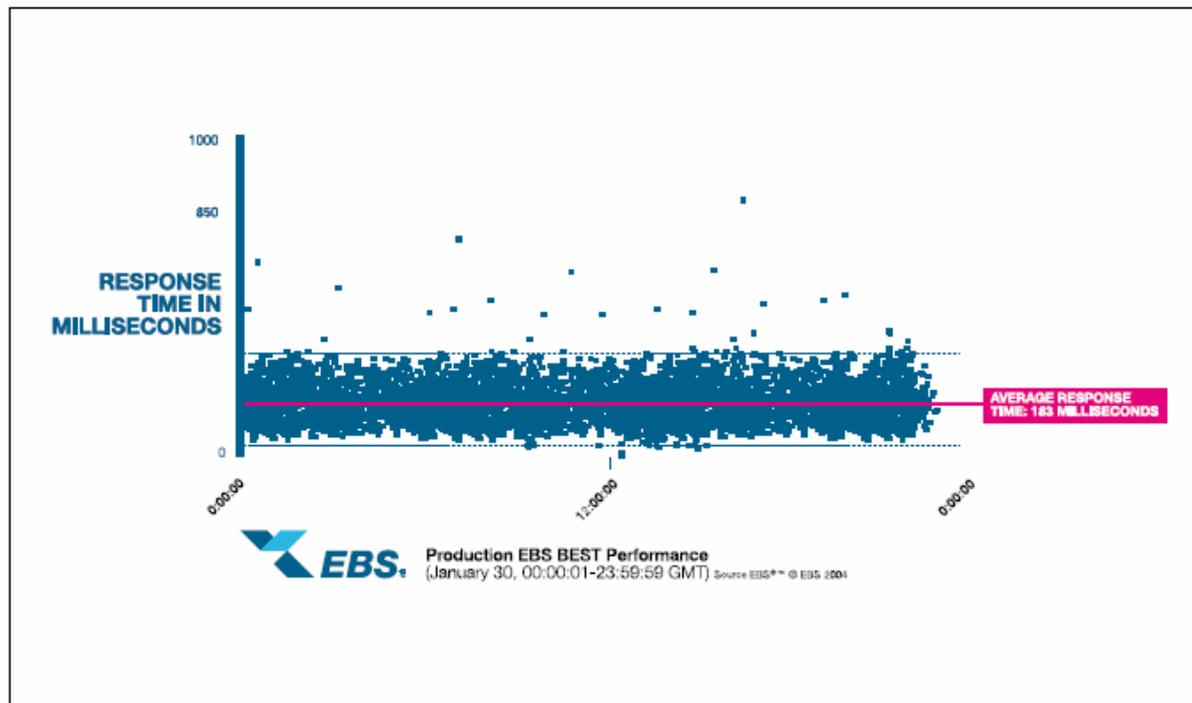
Prime Broking fees

- Commission or fees charged for a transaction
- Brokerage fees can be structured in lots of different ways:
 - A percentage of the contract value
 - A flat fee
 - A mixture of these two methods

⇒ What would be the 'right' commission / fee?

Latency arbitrage

- Delay of 0.1 sec cost money => need to be real time
- Latency reduces the competitiveness of the product
- Latency encourage clients to arbitrage among various price feeds



Future

Discussion

- Is there a risk of creating a duopoly if EBS and Reuters are the source for e-pricing?
- Does cutting out intermediates equal the end of human trading?
- Is it appropriate for EBS and Reuters to further open up to the buy side?
- Other?

Implications / Discussion

- As Volumes increase will market risk or operational (technological) risk be more of an issue ?
- What will be the future growth areas? Are Emerging Markets gaining traction ?
- Sell-side race for market share and buy-side empowerment have fuelled unrestrained liquidity provision. Are we at a turning point?
- Is electronic, commission-based execution appropriate for active large buy-side clients?
- Will regulatory factors affect the development path of e-trading in FX?
- Will integrated multi-asset e-commerce grow in future?
- Is a centralized exchange-based model a foregone conclusion? What are the obstacles?
- Will an unbundling of services occur in the FX Markets?

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