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FX Week

Lehman's fall leads to liquidity drought

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GLOBAL - Heightened concerns over counterparty credit risk caused a dry-up of liquidity in the currency markets last week, as dealers feared a domino effect from the collapse of Lehman Brothers on Sunday, September 14.

Dealers cut lines to a wavering AIG, hitting trading on electronic trading platforms such as Currenex and Bloomberg Tradebook FX, where AIG was a central clearer (see related article, this issue). Meanwhile, lines were decreased to Morgan Stanley and Goldman Sachs after the sustainability of their standalone investment banking business model was thrown into question.

"AIG was a main central counterparty to many of the trades transacted on Currenex, and it was a large prime broker to a lot of the trading you saw on Hotspot, Currenex and FXall," said one hedge funds manager. "Lehman Brothers was a powerful force in the foreign exchange liquidity-providing realm and now it has gone."

Martin Wiedmann, head of global FX sales and distribution at Credit Suisse in Zurich, agreed the illiquidity after the Lehman Brothers Chapter 11 filing had not been seen before. "We have not seen such extreme liquidity situations before. These are extreme stressed scenarios."

Josh Levy, managing director at New York-based proprietary trading company, Tactical Asset Management, noted spreads were inordinately wide. "Even in GBP/USD there were points, especially over the Asian session, where spreads were being quoted up to 11 pips wide [across electronic platforms]," he said. "I believe it's really just stake building because the currency markets have not been unacceptably volatile, certainly not more volatile than what we've seen in the past 18 months."

A London-based head of foreign exchange sales agreed dealers had reduced lines to any banks the market perceived could be in danger, such as Morgan Stanley, Goldman Sachs and Merrill Lynch. "We don't know whether we are coming to the end of this bizarre circle, if we're in the middle of it or just starting. It's something we'll know more about by the end of the year," he said.

He expects this latest crisis will lead to a reduction in the number of players in the foreign exchange market. "The market's finding that liquidity is much scarcer now than it was six months ago or a year ago. A lot of the clients, such as algorithmic trading clients, that thrived off an environment where there's ample liquidity will back-test their models to the wider spreads the market is now trading off of and will realise they haven't got a viable business venture."

Tactical Asset Management's Levy disagreed and instead argued the biggest liquidity providers by flow, be they sell-side or buy-side market makers, need to step up to the plate. "The currency futures market is doing gangbuster volumes never before seen in the history of futures. These guys post bids and offers on Hotspot, Currenex or wherever they can that lean on bids and offers that might exist or be floating out there on the futures market. They really need to step back in and assume more risk - I can guarantee you that along with that risk will come reward."

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