E-FX PORTALS: THE EFFECT ON COSTS

AT A RECENT ROUNDTABLE DISCUSSION ON THE FUTURE OF FX TRADING, ORGANISED BY **FINANCIAL NEWS**, THE PARTICIPANTS LOOKED AT HOW THE NEW PLATFORMS WILL AFFECT LIQUIDITY, TURNOVER AND COSTS.

▪ **Janet Lewis.** During the 1990s, the introduction of electronic matching services in the interbank market not only reduced brokerage and back office costs for banks – driving most of the voice brokers out of the spot market – but also cut margins by disintermediating the larger players from their smaller bank customers.

Will the effect on banks' corporate margins be similar with the launch of the new customer-to-dealer multibank platforms and portals, allowing customers to trade directly with each other? How are the new platforms affecting liquidity, turnover and costs in the market?

▪ **Brian Strange.** Well, from the asset management side, the majority of the trading we do on overlay or large tickets is still going to be carried out over the phone. The smaller tickets, as we tidy up accounts as index values change, could be done potentially through some of the portals. One of the concerns now is that we're at the stage of wondering whose portal or platform is going to win out – similar to Betamax or VHS with video recorders.

▪ **Janet Lewis.** How many do you think the market can support?

▪ **David Woods.** Two or three – no more. I share Brian's view that for smaller transactions the multibank portal probably has a long-term role to play, but for larger players in the market – fund managers or corporates – technology is likely to overtake multibank portals.

We're close already to being able to take feeds from banks' own multiproduct customer applications, put them all on to the customer's own site, so you can create a customised multidealer portal with windows on your screen to compare prices. For the big users, that will be the way to do business in two or three years' time.

▪ **Roddy Boulton.** Perhaps for the really big customers, not for most corporates or funds. And execution is just one part of what's happening. It's about the replication of the entire trade cycle for the user from the pre trade analysis of position to the calculation of risk and the recognising of position, through execution and input of the final deal directly into the system.

A tailor-made solution may be good for some, but it's not the answer for the entire market. As for how many systems there will be, I'd say a minimum of two. I expect a big shake-up in the next 12 months.

▪ **Shawn McMorran.** Over the next six months there will be functional parity between the different systems, then you'll see a

Financial News roundtable participants

- **Roddy Boulton** is the General Manager of Currenex operations in Europe, the Middle East and Africa.
- **David Creed** is Chief Executive of The Association of Corporate Treasurers.
- **Paul Duncombe** is Deputy Managing Director at State Street Global Advisors.
- **Clive LaBand** is Senior Channel Manager for foreign exchange and fixed income utilities at Standard Chartered Bank.
- **Janet Lewis** is Features Editor at *Financial News*.
- **Shawn McMorran** is President of SunGard's online trading platform, STN Treasury.
- **Robin Poynder** manages HSBC's e-commerce group for treasury and capital markets, and is President of ACI UK, the foreign exchange and financial markets professional association.
- **Jonathan Quin** is a Vice President in global FX and e-commerce at Citibank.
- **Brian Strange** has been a Client Portfolio Manager in the currency group of JP Morgan Fleming Asset Management since 2000.
- **David Woods** is a Managing Director of ABN AMRO, responsible for e-commerce for the global financial markets.

differentiation on their customer bases – corporates, asset managers, retail brokerage, securities processors and so on. It's very difficult to say at this stage which will prevail – it is like looking at five one-year-old children and saying what they will be when they grow up. It may depend on the ownership structures of the platforms or possibly their drive and willingness to innovate.

▪ **Janet Lewis.** How important are the ownership structures? Can banks, as owners, direct their liquidity to their own platforms?

▪ **David Woods.** In theory, they can – but that shouldn't be the distinguishing factor, in the long term. The servicing for clients, particularly at the back end, is what will probably determine the winner. So far, no one is really properly offering complete straight through processing.

▪ **Roddy Boulton.** I think the answer to the question of which platform will prevail is liquidity – which will depend on factors such as innovation, responsiveness, ability to deal with customers and costs and how they roll out new technology. There is already some distance between the platforms, and over the next three to six months you will see a big change in the dynamics of this market.

▪ **Janet Lewis.** You don't think it will work as it did in the interbank market, with EBS overtaking Reuters because its bank owners put their liquidity into it?

▪ **Roddy Boulton.** That was a supply-side event – they were not dealing with their customers. In this case, liquidity is not simply driven by the banks – created in response to customers' demands. So the choice of platform will be driven by what customers find useful – the banks will follow because the customers will be there. It's about choice. Do you want an internet connection because it's cheap, or do you want to spend money and have a private connection? The choice has to be there.

▪ **David Woods.** I agree that the parallel with EBS and Reuters is a limited one because both are interdealer systems. You can't just tell the head traders to use it because you paid for the thing. With a customer platform, the customers will go to the one where the service is better. If customers say to their banks, we prefer to use this, they can't be forced to use the one where the banks are pushing their liquidity.

▪ **David Creed.** It's also about perfect linkages. For larger corporates, the platform has to hook easily into their treasury management systems. The ability of the platform to provide multi-ticketed, multiple transactions into the corporate business and from there on into the subsidiaries' own accounts within the corporate is crucial. That's why the platform needs to be linked into the treasury management system, which is set up to recognise the in-house banking structure of a large corporate treasury, when it is acting as agent for the subsidiaries.

The platforms will also differentiate themselves by whether they are targeting the large corporate or the small corporate. For a small company, it has to work well on a website and be easy to use. Otherwise, a small company with perhaps only a part-time treasurer, who usually deals with one relationship bank, might give it a one-shot try, and unless it's better and gives him the information he wants easily, he might give up in frustration.

The other problem is the way you use an independent platform can change your relationships with banks. Many corporates have complex relationships with their key banks and by carving out a certain element of activity, foreign exchange, they then shift that relationship. If they use a platform partly owned by one of their banks, that's just dealing with the bank in another way. But if it is a completely independent platform, you can no longer put forward the argument that you are giving a bank your FX business as part of your overall relationship. Treasurers will have to think quite carefully about how they use platforms.

▪ **Janet Lewis.** How well do the new platforms handle credit and settlement issues?

▪ **Brian Strange.** Well, our dealers say the credit issue is difficult for them to do, and to allocate different tickets down to the individual accounts – it's something they are not doing that well.

▪ **Roddy Boulton.** Our approach was that we do not really want to get involved in credit because every bank has a different way of looking at it.

It is so far better that counterparties know each other, give each other permission to trade and set their own limits. But in the future if there is some sort of exchange, then clearly the credit system on which it operates is going to be critical. But I don't see that happening in the next year or two.

BRIAN STRANGE: 'WE'RE AT THE STAGE OF WONDERING WHOSE PORTAL OR PLATFORM IS GOING TO WIN OUT – LIKE BETAMAX OR VHS WITH VIDEO RECORDERS'

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▪ **Janet Lewis.** Can the platforms allow customers to trade directly with each other, further disintermediating the banks? Is a true exchange needed for the FX market?

▪ **Jonathan Quin.** I really don't see that happening. The fundamental problem is that corporates and investors normally want or need to deal in specific amounts for specific dates. The chances of those matching are fairly small and so there is the need for an intermediary liquidity provider, which is where the banks come in.

▪ **Paul Duncombe.** It's extremely unlikely that we would want to pursue that.

▪ **Shawn McMorran.** Those driving that idea are largely hedge funds and commodities trading advisers (CTAs) who want to avoid being front-run by their banks. Anonymity is the key factor.

▪ **Roddy Boulton.** There is already an exchange in the FX market between customers today, for small amounts in big currencies. Because often you can ring up a bank and they'll make you a choice price, or a one-tick price.

So if it's a choice price, then isn't that an exchange with the bank acting as an intermediary? It's as narrow a price as you can get. But for the big tickets, or the ones that are difficult to match then there'll always be a role for the bank there as the risk taker in the market, as the supplier of liquidity. However, there is a lot of interest out there from our customer base to have at least the ability to trade with anyone that they may want to trade with, as a matter of choice for them.

▪ **Clive LaBand.** There's a very good analogy with the used car market in the UK. If you buy from or sell to a private individual, you may get a better price, but the risks are higher. The foreign exchange market is just the same – the risks are there.

▪ **David Creed.** The analogy doesn't quite work on credit risk – some corporates are probably more attractive than some banks. If we see a continuing reduction of the credit standing of banks, you might find that corporates want to deal with other corporates as far as credit risk is concerned, but neither corporate wants to take on the market risk. There, unbundling of the two may be a good idea.

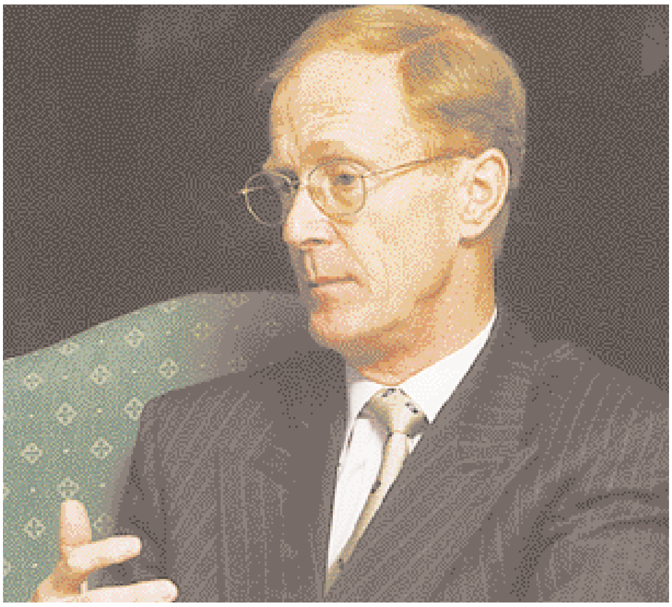
▪ **Robin Poynder.** It depends on ticket size. You might find some corporate customers wanting to trade with other corporate customers in spot in a $10m size. That's really because the commodity is homogenous. For really small sizes, people don't really want to bother, because it's not very efficient. And for very large sizes, you need a bank that can deal with that kind of liquidity.

That middle tier, if you like, is more fungible and could be more possible for corporate-to-corporate dealing. If you look at the function of the FX market as a whole it operates as an exchange anyway, it's just that it's not formalised within one environment.

▪ **Janet Lewis.** The thing that's missing is more the processing end of it.

▪ **Robin Poynder.** As Shawn said, the multibank platforms are getting toward the same degree of functionality, so technology is no longer the issue for evolution of the model. It's in the business processing behind it – the STP that you are offering to the customer.

DAVID CREED: 'THE PLATFORM NEEDS TO BE LINKED INTO THE TREASURY MANAGEMENT SYSTEMS, WHICH ARE SET UP TO THE IN-HOUSE STRUCTURE OF A LARGE CORPORATE TREASURY'



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▪ **Jonathan Quin.** Definitely. In 2000, everybody was talking about price – how is the system going to deliver the best price? But last year, everyone was talking about efficiency.

▪ **Janet Lewis.** How long do you think it will take for customers to trust these platforms for bigger transactions?

▪ **Paul Duncombe.** I think it'll be a long time – a very long time, because using a platform changes the whole nature of the banking relationship. If I am sticking a $1m trade on a platform, that's fine, quick and simple. But if I'm trading $300m or $400m then I want to talk about market conditions, I want to find out what liquidity is like this morning, I want to find where the orders are sitting in the market. I'm never going do that down an electronic portal. But having transacted that $400m trade, however we've done it, it will be broken down into 10 or 20 underlying portfolios. And those details will then go down the portal for various maturity dates and forward points, to reduce errors, settlement and operational risk.

▪ **Shawn McMorran.** As the liquidity gets constructed from those small tickets, eventually, that treasurer jacks up the limit from $1m to $5m to $9m. And then to $10m. And at some point that portal gets enough flow to become an information source for where the market is, when you want to execute that larger ticket.

▪ **Roddy Boulton.** We have to get away from being hung up on execution and think more about processing. You know, that billion

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JONATHAN QUIN (LEFT): 'IN 2000 EVERYBODY WAS TALKING ABOUT PRICE – BUT LAST YEAR, EVERYONE WAS TALKING ABOUT EFFICIENCY'

dollar ticket that you'd never dream of doing electronically – if you did do it electronically you might get a wider spread. There's another question about what platforms do to spreads in the marketplace. What I say to our customers is, please don't do that trade on-line. But do it on the phone and then book it on the system because then you get the ancillary benefits of straight through processing. But at some point quite soon there'll be a market available for customers that gives the complete depth of the market available at executable prices, in amounts good for what you see on the screen. And there will be people who will do the billion dollar ticket because the cost of splitting that into a hundred different tickets will be minimal.

▪ **Clive LaBand.** The information contained in the portal is really important, however. If you go into a multibank portal and shift $400m, you must realise that you're actually asking five or 10 banks for the price. They all know. If you make the phone call, the information is private, with the one bank, the smaller the market, the less liquidity there is, the more valuable that information becomes.

▪ **Jonathan Quin.** But if the portals become sufficiently successful they may become a more transparent way of trading.

▪ **Robin Poynder.** There will be a migration of the liquidity, and size to these platforms, as there was with the interbank matching systems. But when the banks moved over to those systems, there was some motivation for them to do it because they didn't have that liquidity access elsewhere. But since banks are already the liquidity providers to the corporate customers, corporate customers don't have as much motivation to find that liquidity somewhere else.

▪ **Janet Lewis.** Are the banks in some respects shooting themselves in the foot by backing these portals? Won't they lose some of their margin?

▪ **Robin Poynder.** No, I don't think so. It's a reflection of the reality of the market that some corporate customers require that kind of service and the banks are in the business of providing service. Some of the services you provide over time give you less margin. Well, that's always been the case, it's an ongoing process. We see this as just another way in which our customers can deal with us. It's not some new paradigm.

▪ **Jonathan Quin.** For the banks, it was a necessary evil. Certainly, that question entered into some of our discussions, but we had to make sure we did it ourselves, or someone else was going to take that opportunity. We are protecting our long-term position, despite a potential short-term or medium-term loss of revenue.

▪ **Janet Lewis.** Has there been an effect on spreads already or on liquidity?

▪ **Robin Poynder.** That's still to come. Obviously portals are a very small percentage of the overall market at the moment. Customers are still trying them out, or have signed up but have not started trading yet. So when they're all signed up and when they're all using the systems, then we'll be able to judge better.

▪ **Janet Lewis.** David and Paul were talking about the importance of their banking relationships.

▪ **David Creed.** It's also the personal relationship – foreign exchange dealers who talk to each other get a feel for the market, and if the corporate has any element of dynamic hedging, any judgement input to make, the traders will decide when to exercise that judgement. Therefore, building a relationship with a relatively small number of counterparties will continue to be an important element among corporates, unless they go over totally to rule-based trades, which I think is unlikely, although the trend is in that direction.

▪ **Roddy Boulton.** I used to run a foreign exchange sales desk and I reckon that people working with me spent 20% of their time booking tickets – that was 20% of the time when they were not able to talk to their clients. Portals are a great way of adding 20% more time to talk to your clients. This will be an enabling tool that will free up the sales person and the trader to understand the market, then just simply execute it electronically.

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The roundtable included sections on: The effects of the euro and consolidation in banking; Corporates and asset managers in the market; Prime brokerage in the FX market; and, Looking into the future.

Copies of the full supplement, published on 28 January 2002, are available from *Financial News*.
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