CHANNEL HOPPING, FX STYLE

AFTER INITIAL SLOW TAKE-UP, THE MARKET FOR MULTIBANK FOREIGN EXCHANGE PLATFORMS APPEARS AT LAST TO BE GROWING. **JUSTYN TRENNER** AND **ANNE QUERÉE** OF CLIENTKNOWLEDGE THINK THE FUTURE IS STILL MULTICHANNEL.

It has been a rough ride so far for the multi-bank online Foreign Exchange (FX) platforms, as users have been slower than expected to sign up. Our research shows that a damaging cycle of hype and anti-hype left potential users of these new channels to FX confused by the choices last year and this, in turn, acted as a serious brake on potential growth. But there are promising signs that the market is now growing – albeit from a slow base.

According to ClientKnowledge's FX Study 2002, last year (to June 2002), 4% of European companies were trading between 1% and 25% of their FX through a multi-provider platform (MPP), and a further 6% were trading more than 50% of their volumes this way. But next year, 14% of businesses in Europe expect to trade up to 25% of their FX via MPPs, and 13% will trade more than 50%, indicating a strong appetite among existing users to trade more electronically. Predicted growth figures for the US market are more promising still. Here, the 9% of treasurers trading more than 50% of their FX through an MPP last year looks set to grow to 15% the next. In Asia Pacific, 4% of companies will trade more than 50% via MPPs next year, compared with 2% last year.

If this bodes well for the future development of MPPs, it also begs two important questions: what changes are underway that will significantly affect market behaviour and needs in the future, and how should providers of FX respond? Below, we identify some key market requirements.

AT LAST, LIBERALISATION OF LIQUIDITY. A seemingly negative development, namely the closure of Atriax in April, has in fact had the positive effect of increasing the choice of banks available through the MPPs. For example, following the closure, Citibank moved to provide liquidity to FXall and FX Connect (the latter targets principally institutional users), Deutsche Bank to FXall and Currenex (in addition to FX Connect) and JP Morgan to all three MPPs, allowing potential users to trade with more of their FX banks through more channels.

LESS FRAGMENTATION, MORE SEGMENTATION. Also good news is that there are fewer multi-bank providers competing for the same target clients, while new models are emerging that aim to serve the particular needs of specific areas of the market. In other words, the market is in better shape, with clearer strategies for serving client needs. State Street made an impressive start on this by targeting institutional buyers of FX with GlobalLink's FX Connect in 2000, while FXall could arguably be a provider of choice to high volume, trading-oriented clients (an EBS for the buy-side). Other examples of a segmenting market include Centradia, which targets mid-market companies with a multi-lingual, multi-product offer providing access to multi-bank pricing via an existing banking relationship. Other multi-product sites include GlobalLink and 360T Treasury Systems. Currenex has had some success with clients wishing to integrate FX with enterprise resource planning (ERP) systems, and is also offering online FX prime brokerage. Other providers, meanwhile, such as Hotspot FX, target margin trading business.

DIRECT PROCUREMENT. An important emerging model recognises the essentially bilateral nature of FX trading and links the buy-side with the sell-side counterparties specified. This model, which we call 'direct procurement,' mimics the e-procurement models developed for business-to-business purchasing of non-financial goods and services, and is represented by services such as 360T Treasury Systems. (In equities, the direct procurement model has become established using the FIX standard to connect trade order management systems to e-brokerage services).

Buy-side advantages of this approach are that it delivers the FX markets to the buy-side's own environment, allowing for close integration with trade order/treasury management systems or company intranets/enterprise portals, facilitating straight-through processing (STP). This model can also reinforce strategic partnerships between large firms and their privileged FX providers. On the other hand, a complex set-up means implementation costs/time impact on both buy- and sell-sides. This solution is only generally suitable for high-volume users. Importantly, it also has the potential to disintermediate the MPPs or define them as intermediating utilities.

Another potential hazard of direct procurement is the risk of getting locked into standards which later change.

We believe the direct procurement model offers potentially the greatest savings and benefits for those businesses with the necessary scale to take advantage of it precisely because of the close integration it provides with in-house and sell-side pre- and post-trade processing. In our view, both GlobalLink and Currenex's evolution is positioning them for such a role, while FXall's best future may well be as a facilitating intermediary.

STP: MOVING FROM MANTRA TO REALITY. Our research has led us to believe that automating transactions from soup to nuts – and not just at the point of execution – is a much more valuable incentive than marginal price improvements.

STP has become an easy, somewhat hyped, shorthand for process improvements that can, when well-executed, reduce risk and deliver significant savings on both sides of the transaction. By STP, we mean that, on the buy-side, a trade can be executed direct from a trade-order or treasury management system. A single input can automatically update positions and pass the trade details on to the back office for confirmation and settlement. On the sell-side, the bank can also seamlessly process the trade from front-office to back.

Our FX Study 2002 confirmed that purchasers of FX and other financial services value STP. For example, in Europe, institutions rated STP above range of products and liquidity providers in importance when selecting an electronic FX counterparty. A sign of the maturing of the online FX market is the increasing availability of STP solutions.

FIGURE 1
EVOLUTION TO DIRECT PROCUREMENT.

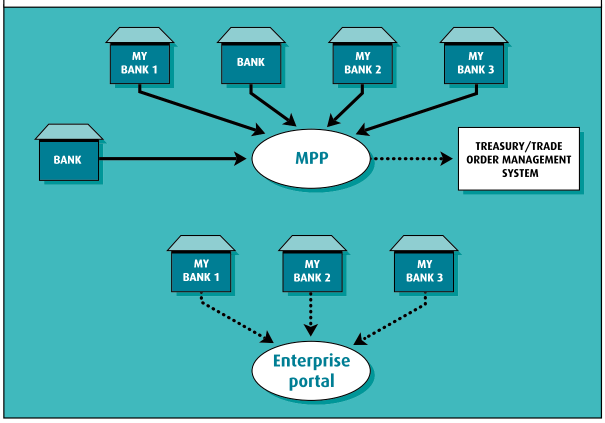
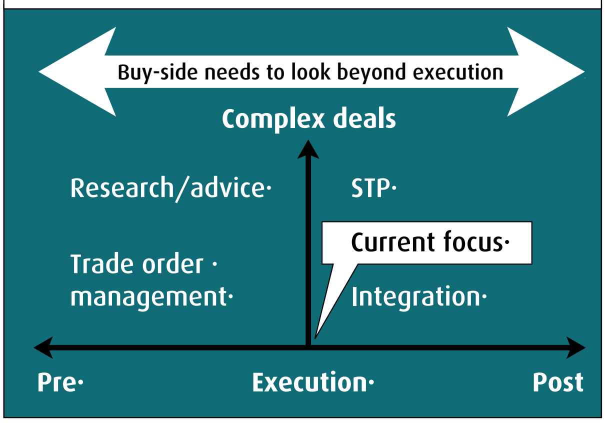


FIGURE 2
NEXT PHASE – LOOKING BEYOND EXECUTION.



All the leading multi-bank platforms have announced initiatives in this area. This usually means developing separate application programming interfaces (APIs) to connect the portal to the different trade order or treasury management systems. XML (eXtensible Mark-up Language) now provides a potentially more cost-effective means of achieving the transportability of data between disparate systems.

SINGLE BANK PLATFORMS STILL IN THE PICTURE. So far in this article we have focused on the developing market for multi-bank FX platforms, but, to date, the online trading platforms provided by certain banks (single bank platforms) have been a quiet success story behind the noisier and more volatile multi-bank scene. We don't see either a multi-bank or a 'one size fits all' solution prevailing in FX anytime soon. Rather, a range of channels (including single bank platforms), answering a variety of needs, will continue to be necessary in a demanding market. The trick for providers will be to have these multiple channels co-exist within a coherent strategy with careful co-ordination of salesforces and marketing messages.

OTHER DRIVERS AND DETERRENTS. We observe in other financial markets that an onerous regulatory environment is acting as a driver towards more electronic management of trading, since best execution requirements and limits can be more easily tracked and recorded. Although the FX markets are not regulated in the same way, FX buyers are subject to ever stricter internal controls and electronic trading can be attractive for the checks and balances it can provide. On the negative side, though, loss (or perceived loss) of personal contact with traders, as well as the paucity of local language sites online, are flagged up in our research as deterrents to the use of these services. In general, the single bank providers do better at catering for non-English speakers than do the multi-bank sites, although Centradia prides itself on this aspect of its offering.

NEXT PHASE: LOOKING BEYOND EXECUTION. These facts signal what we believe to be the necessary next move for the multi-bank providers. We believe they need to provide much richer pre-trade as well as post-trade facilities, by which we mean support for trade processing as opposed to research and analysis.

Today, we see the online FX market growing in confidence and starting to meet the needs of real users in all their complexity. It is important to recognise that, by any measure, this is still a very young market. What providers need to do is continually refocus on the user and remain flexible and adaptable to ensure their business models evolve in line with the market. In this regard, the focus now needs to move away from the point of execution (pricing is pricing in any medium) to the total end-to-end transaction delivery.

THE FUTURE WILL STILL BE MULTI-CHANNEL. Multiple channels to FX are not only here to stay, but, as we have argued, are actually desirable. The buy-side needs to follow its natural instincts in this respect: don't bet on any one winner emerging, but look for real processing savings and the arrangements that will best achieve that for your business.

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