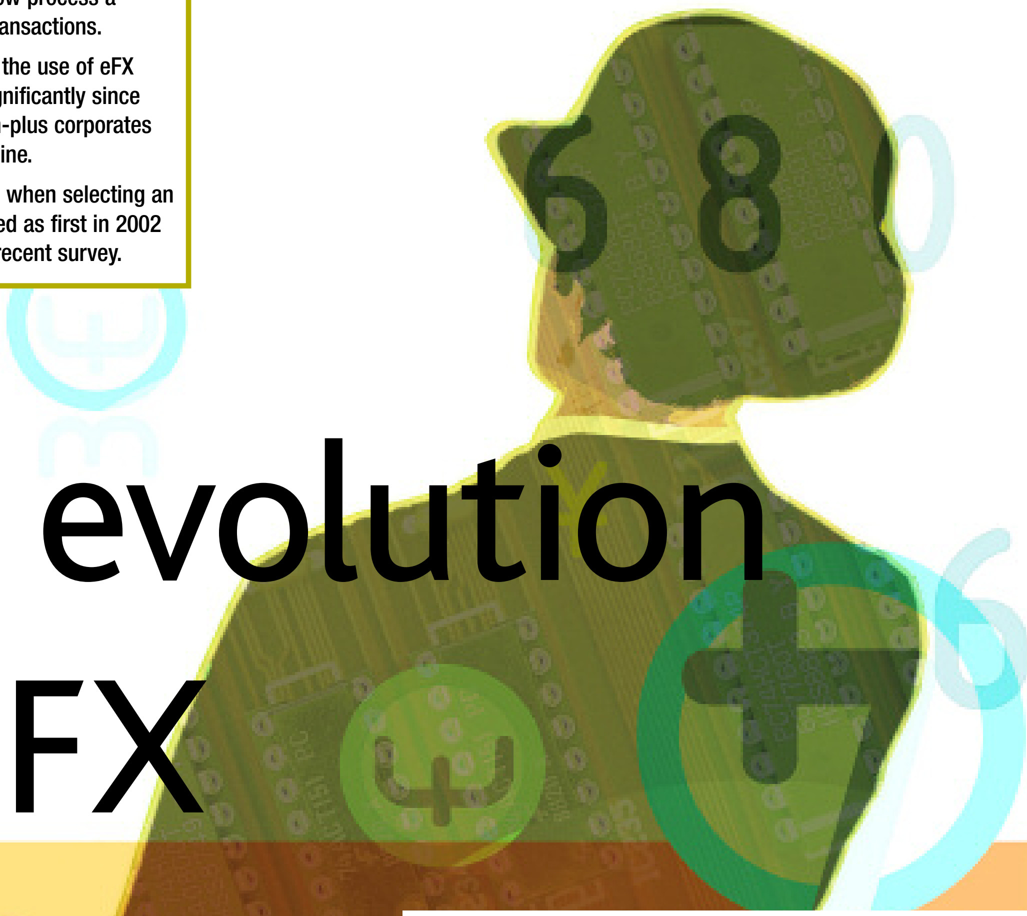
Executive summary

- The introduction of electronic trading platforms has led to radical changes in the FX market over the last decade.
- Electronic trading platforms now process a significant number of global transactions.
- A recent survey indicated that the use of eFX trading platforms has risen significantly since 2002, with almost half of $1bn-plus corporates saying that they now trade online.
- STP has slipped in importance when selecting an online provider. This was ranked as first in 2002 but only appeared fourth in a recent survey.



The evolution of eFX

ELECTRONIC TRADING IN FX IS MORE COST-EFFICIENT AND CAN REDUCE PROCESSING AND PRICE ERRORS. NOT SURPRISINGLY, 40% OF CORORATES NOW USE eFX PLATFORMS. **TOM ROCHE** REPORTS.

Over the last 10 years the foreign exchange (FX) market has undergone dramatic structural change, particularly with the introduction of electronic trading platforms which now process a significant proportion of global transactions. The take-up in electronic trading in FX is much further advanced than in other financial areas such as interest rates. At the macro level, the number of inter-bank FX market liquidity providing participants has declined significantly due to both mergers and acquisitions. These changes in the industry are important for corporate treasurers, not only in terms of day-to-day business but also how they manage bank relationships.

ELECTRONIC TRADING IN FX. Electronic trading platforms match buyers and sellers. They are much more cost-efficient and create materially fewer pricing and processing errors. The evolution to an electronic market has changed the industry structure. There is now much more price transparency in the market; most dealers have instant access to current prices. Meanwhile, corporates can get real-time access to these prices much more easily.

Proprietary versus multi-bank solutions

Theories of financial intermediation tell us that as an economy gets more developed and efficient, the role of the middleman (brokers) in financial transactions declines. With price transparency and good communications we deal directly with our principal business providers. This is an important concept as it brings into question whether brokers (which are what multi-bank platforms are) provide a real economic benefit to society where information is so transparent.

In reality, however, if everyone can see the market price and has to deal at it (or some spread over it based upon their market power), why deal with a broker? Some multi-bank platforms are, nevertheless, doing quite well. Multi-bank portals provide a number of benefits for corporates who can realise improvements in price discovery and straight-through processing (STP) while the banks have a new, sophisticated channel to their client base. This means that multi-bank platforms are here to stay for at least the short-term. From the perspective of the corporate customer, they can be looked at as another potential service provider and assessed in the same way. Do I get good service from the relationship manager or contact? How good is the technology platform, do my trades settle, and do they provide me with any other services that I need? It is, however, fair to say that most of the new bank research and development money spent creating and improving new technology solutions will now be invested in bank proprietary systems.

Royal Skandia invests in eFX

Royal Skandia is one of the largest insurance companies in the Isle of Man and forms an integral part of the UK Skandia Life Group. The company has £4.8bn of assets under management and employs 380 people at its head office. Its parent company, Skandia Insurance Company, is one of Europe's oldest insurance companies and has global operations and assets under management exceeding £48bn.

Skandia has undergone a profound transformation in recent years, redefining itself from primarily a property and casualty insurance company into a savings company.

On the client side, Royal Skandia has embraced a multi-manager approach. It now offers clients a choice of its own internally-managed investment funds or funds from third parties such as Fidelity or JPMorgan Fleming. This multi-manager approach reflects the competitive nature of the investment business and the desire for choice.

An important aspect of corporate culture that translates into all areas of the business is looking at new ways and processes to offer the best service at the lowest cost in a very competitive industry.

Royal Skandia executes a large number of FX transactions daily. It uses the Royal Bank of Scotland's (RBS) FMET system which, according to Joy Morris of Royal Skandia Treasury, executes about 90% of its FX transactions. One of the reasons for choosing FMET was because it is allows FX transactions to be completed online, direct from a PC.

Two important issues in Skandia's business are pricing of financial transactions and error-free execution. "You know when it is going to be settled, at the correct currency and at the correct value date. Because there is no human involvement in it, there is less chance of error. This is a big factor for us," says Ms Morris.

The other important factor in the choice of system was service back-up. Although electronic systems are much less error prone than manual systems, they can, on occasion, have a problem and getting this sorted out by human intervention is critical.

RECENT TRENDS IN eFX USAGE BY CORPORATES. A survey conducted in July revealed that use of eFX trading platforms by corporates has risen significantly since 2002. Previously, only 18% were using eFX platforms, whereas in 2004 this rose to 40%. Almost half of $1bn-plus corporates (46%) said they now trade online.

The survey also revealed that 25% of corporates had increased their number of counterparties since trading online, and that 31% had increased the proportion of business conducted with their top three counterparties. The financial landscape is changing and this is tempting corporates to try new providers that have come on the scene, including multi-bank portals. However, given the price transparency in the market, there is a trend to concentrate business with key relationships. There is simply little benefit to be had by shopping for many prices in a highly-transparent market.

Straight-through processing (STP) has slipped in importance when selecting an online provider. This was ranked first in 2002 but only appeared fourth in this year's survey.

STRAIGHT-THROUGH PROCESSING. It requires a great amount of investment to get a treasury's systems to the point that they can interface with counterparties. To assess where your treasury is, you need to ask which of the following three options reflect your systems' levels:

- A corporation that has aspects of manual processing in its systems cannot look for pure STP and will still rely on a voice interface with its bank to operationally trade or confirm and settle transactions.
- The next level of sophistication is when the corporate has internal STP but chooses to manually submit trades to its bank via, say, excel files (or by voice). There is STP within the corporate and the bank, but not between the two parties.
- The ultimate progression is where the corporate's and bank's servers fully interface via an application program interface (API).

If your corporate treasury has internal STP, it becomes a strategic issue about whether you want to go to stage three or stay at stage two. High levels of encryption are possible to ensure the security of transactions.

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