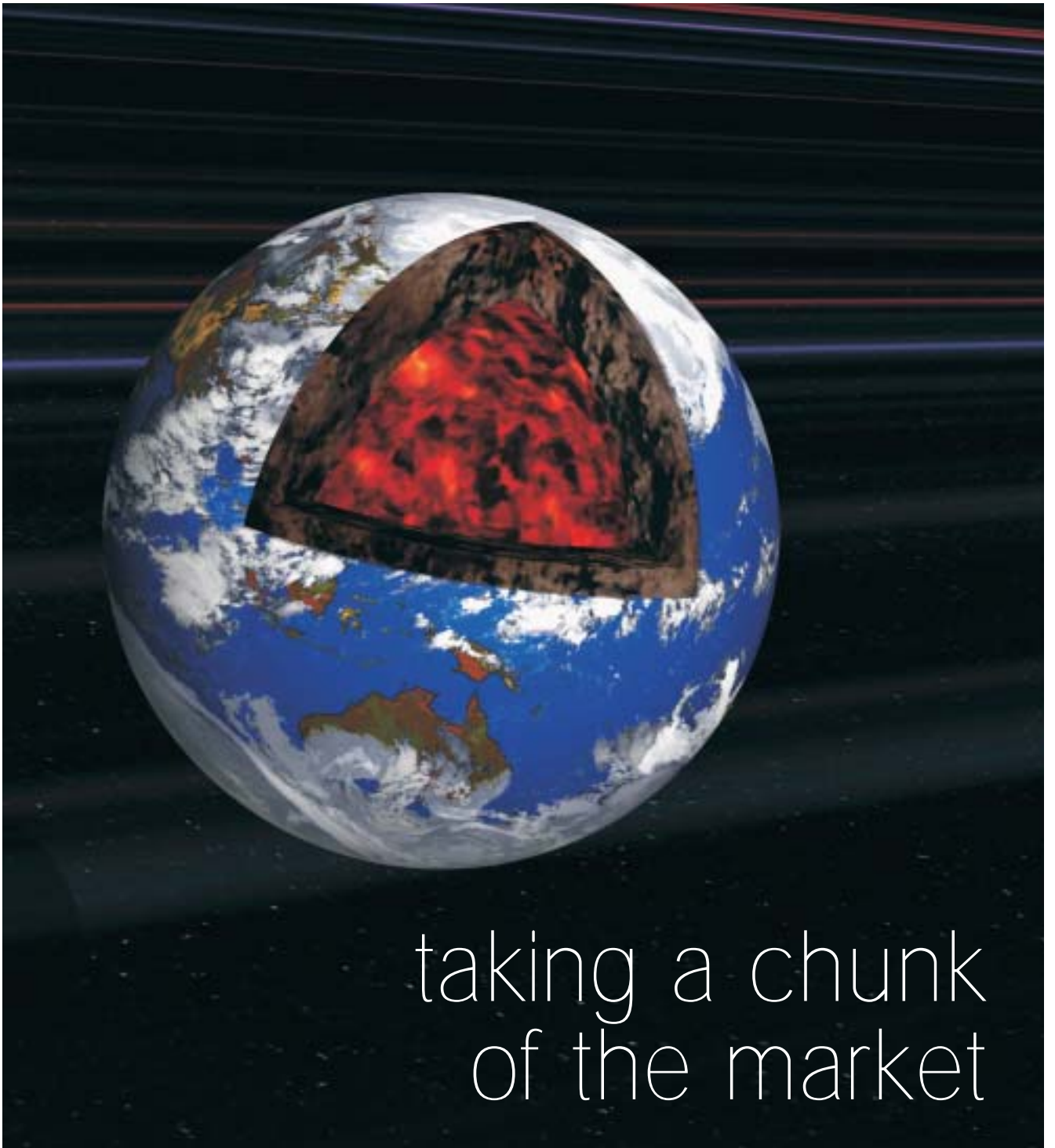


Electronic foreign exchange



After a sluggish start, electronic foreign exchange (e-fx) trading is poised to erupt. The market is becoming increasingly defined as offerings slip into niche sectors in a drive to differentiate.

Ross Butler profiles the major systems, and reveals which have the functionality and the backing to survive

Currently saturated with under-utilised offerings, the nascent e-fx market is predicted to swallow up a third of the \$2 trillion fx market inside a year¹. Nevertheless, much of the fat will soon be cut off the market as companies jostle to establish their position. The market for e-fx options, for example, is only expected to support two to three trading systems, and only two to three systems in the wider institutional fx market are thought to be viable. One portal, CFOweb, has already fallen in the fight for liquidity. What will systems need to offer to harness this market?

Adoption of e-fx trading began painfully slowly, with most multi-bank offerings not hitting the market until the middle of 2001. However, the first-mover advantage of FXConnect and then Currenex in the institutional market, Gain Capital in the retail sector and Volbroker in fx options will now be tested as offerings consolidate and powerful players enter the arena. Atriax has the strongest base, with the heavyweight fx backing of Citibank, JP Morgan and Deutsche Bank, closely followed by FXall in the institutional sector, while independent portal Currenex has the firmest following of corporates and funds. However, State Street-owned FXConnect's four year head start on most multi-bank portals means it continues to retain an estimated 70% share of the online market. Sungard's STN Treasury, which has most recently entered the fx fray, is tapping its existing infrastructure to secure its existing client base.

"With the backing of the big banks, Atriax and FXall should have logically the strongest chance of succeeding," says David Woods, head of e-commerce at ABN Amro. "Currenex still has first-mover advantage, but it needs

to retain that, given that the banks are not major shareholders." Currenex's marketing director Karen Steele believes: "Independence facilitates an open marketplace, which drives innovation, with equal interest in the buy and sell-side." This lack of bias makes it especially popular with corporates. Woods notes: "The marginal cost of participating on Currenex for banks is relatively low. However, if it comes to a liquidity crunch, the leverage of bank-owned platforms, with shareholding liquidity providers, could be greater than Currenex's leverage." One market participant observes that bank-owned systems may distort the market by supporting inefficiencies. "The multi-bank portals don't ever have to make money as they are backed by banks that make great money in fx. The online space threatens that; they will be disintermediated."

Technology

Vested interests aside, the market will judge portals on the suitability of their technology. A year ago everyone was touting the same benefits of e-trading, such as real-time prices, transparency, anonymity and so on. Now portals are starting to assume technological identities. However, the one thing that has not changed is the pursuit of complete automation.

"It is arguable whether merely executing a deal through an e-portal is any more efficient than doing it over the telephone," notes an Atriax spokesman. "However, STP makes a huge difference." Automating the whole dealing process, and so cutting out the operational costs and errors that accrue to manual intervention, is e-trading's Holy Grail. Atriax believes that "dealing engines are the missing link in the piecemeal automation of the FX business lifecycle". To achieve full post-deal

STP, Atriax has developed AtriaxAdapt, a software product that links the dealing engine to a large number of proprietary treasury and portfolio management systems.

STP is the forte of Sungard's STN offering. With a huge client base of portfolio managers and corporate treasurers, and a vast extant technological infrastructure, STN has the edge in connectivity. "No other platform automates so much of the workflow because they do not integrate directly with trade and settlement systems," says Ben Auld at Sungard. "STN Treasury offers seamlessly integrated market access. Among the processes we deliver straight-through, we automatically supply position management and trade aggregation for the buy-side, and credit risk and spread management for the sell-side. Post-trade workflow is automatically fed back into the trading and settlement systems. We feel that our technology is our advantage."

While the e-marketplace brings the possibility of total automation, Alex Stevenson at Principia Partners pinpoints the elusiveness of STP. "Most of the breakage that occurs in the dealing process is two people agreeing a trade. With automated exchanges like Atriax and FXall, the agreement is electronic, but with term agreements the process often breaks." Stevenson believes there are still a number of things left to chance with respect to settlement terms, but it is possible to incorporate them. "If you use settlement terms as part of the negotiation, with higher prices for greater complexities of settlement instructions, then it is possible for everything to be done straight through, on both sides."

The next step

In addition to efficiencies of STP, traditional advantages of electronic trading are evolving diversely, as offerings dif-

ferentiate. Supplying real-time market data and information is no longer the coup it once was, and the next step is letting traders see the depth of the market. Hotspot FX, an ECN designed for large inter-hedge fund trading, gives access to all the trades and offers on the system. "Showing traders the depth of book deals allows them to see where the market as a whole is going, and not a momentary snapshot," says David Ogg, Hotspot's ceo. Atriax's Management Information System is a suite of reporting functions that expands the scope of deal audit. "Price-takers can access not just the prices on which they dealt, but the competing quotes they declined, because our MIS records every event surrounding each deal," says the Atriax spokesman. "This allows price-makers to demonstrate that best execution was achieved and quantify the value of this." Similarly, price-takers can see how well they compete in particular currencies, and pinpoint systemic strengths or weaknesses in their quoting capabilities.

Until Hotspot goes live, ECNs remain e-fx science fiction, but Currenex's Enhanced Market Access (EMA) moves the market closer to a true exchange. Because of the perceived high risk of fx, traders are traditionally constrained to their credit counterparty relationships. EMA extends the concept of prime brokerage, allowing banks to lend out the credit lines they have with other banks to a corporate customer. "This process greatly increases liquidity for a corporation or fund, and business for a bank, without significantly increasing the administrative burden of managing credit relationships," says Lori Mirek, Currenex's president. The system allows banks to earn income from lending out their balance sheet for credit purposes, on top of the traditional fx income for market risk, while the client can make better use of its credit lines and capital. "We are working with both the buy and the sell-side to move closer to a true exchange," says Mirek. While some claim that the e-fx market is not ready for this and cite security difficulties, the system pushes the fx market closer towards the maturity and ease of access of other markets.

Systems providers are eager to retain the ease and immediacy of telephone trading, ranging from clear display of market data to an assault on the senses. Tom Binks, European head of Icor Brokerage, an inter-dealer e-fx



Lori Mirek

As well as aesthetics, the medium of electronic trading can also affect the speed and accuracy of data



Tom Binks

broking system, explains: "We are replicating, as far as possible, the experience a trader has with a broker. It is therefore user-friendly, straightforward and intuitive." Like many systems, Icor uses colour coding, because the brain processes colours 100 times faster than figures. Meanwhile Currenex is taking the GUI (graphical user interface - the point of interaction of technology with user) another step, with telephone ringing sounds when a deal is coming in and gongs alerting the trader to confirmations. However, Principia's Stevenson, who designed the software for Atriax, comments: "You don't have to exactly replicate the telephone experience, but you do need to replicate the trading process. Different corporate customers trade in different ways, and it is interesting to see how the exchanges have responded to that." Systems must therefore support multiple trading models, which the GUI must replicate. Stevenson believes that Atriax, FXall and Currenex all succeed in giving the corporate the opportunity to choose its trading style. "Simplicity is key," he emphasises. "There must be no clutter, especially in fx, where things move so fast."

As well as aesthetics, the medium of electronic trading can also affect the speed and accuracy of data. Traders must decide whether to trade over the Internet, or via a virtual private network (VPN). "Banks are generally linked to exchanges directly by the platform," says Principia's Stevenson, "but for corporate customers Internet response time is good enough, provided they have a hosting vendor with good links to the main ISP. However, in adverse conditions response times will increase, and this is just when you need reliability." As a result, there has been a general move away from the Internet to VPNs such as Radianz, a Reuters networking company that is the current provider of choice. ABN Amro's Woods notes, however, that because a direct VPN connection is more expensive than dealing over the Internet, banks do not necessarily jump straight in to full connectivity. "In practice, we are connected to some through VPNs and others purely over the Internet. There is a review process before we take the step to participate on the VPN, where we

make a decision on the future viability of the platform. But once a platform starts to show real traction and volumes, the ability to compete as a bank just over the public Internet is not great," he says.

While technological nuances may eventually help sway the market towards a particular offering, the electronic interbank market for fx options is currently being dominated by two increasingly hybrid offerings. Volbroker, which has maintained its first-mover advantage (it has retained over half the e-fx options market), is in a powerful position as a consortium-led offering of six banks. Its main competitor, GFInet, is independent from bank ownership, which it says gives confidence and guarantees an unbiased trading environment. It claims that over 120 banks have agreed to take the service. GFInet also owns Fenics fx options pricing software, the market-leading tool, used by one of Volbroker's investing partners.

GFInet FX Options is a hybrid online and voice-trading platform that offers vanilla options and voice support for exotic options. With striking symmetry, Volbroker integrated with inter-dealer brokers, Icap, in December to create an

inter-dealer broking consortium that combines voice and electronic trading. While this may be a simple tactical matching of offerings, it also highlights the continued need for voice-broking more exotic contracts. Icor Brokerage's Tom Binks explains the difficulty of trading relatively illiquid options electronically: "An electronic platform cannot get involved in less liquid products as voice brokers are much better at structuring more complex products, so we cater for the more substantial, simple end of the market." Icor, which recently joined with Reuters to offer fx options via the Reuters 3000 platform, initially in Asia-Pacific, plans to concentrate on plain vanilla and simple exotic options. Nevertheless, Volbroker for one, is keen to emphasise that the efficiency of online trading is its key focus.

FXall and Atrix, in their battle of promises and press releases, both intend to offer fx options in the future. STN treasury offers options, as well as swaps and futures, on request, as does Currenex. Forex Capital Markets (FXCM) and Gain Capital both seek to offer options around mid-2002 (see box). However, in the corporate market at least, one observer notes that options "depend on demand from a corporate standpoint, and there is cur-

rently more initial take-up from spot than derivatives".

So what is separating the men from the boys in e-fx and e-fx options platforms? At the moment it is hard to tell. Looking at backers and liquidity providers is increasingly irrelevant as banks hedge their bets by participating in many offerings. ABN Amro, for one, provides liquidity on all five interbank platforms. Four of Volbroker's partners also invest in FXall, and the rest have a stake in Atrix. To further confound the incestuous competition, banks also want their individual offerings to prosper. Two individual e-fx options platforms of note are Goldman Sachs' WebET, and UBS Warburg's e-fx system, both of which invest in Volbroker. ABN Amro's Woods reveals the not-so hidden agendas of the e-fx world. "We have invested significant sums in electronic trading, and we want to see a return on that investment. However, if multi-bank portals continue to grow slowly and individual bank portals take off, we will be delighted." □

This is the first in a series of FOW articles analysing electronic trading systems

¹ Robert Lati, *Electronic FX Systems: An Update*, (September 2001) Tower Group

A retail revolution

So far, the retail sector has benefited most from the advent of e-fx. "Traditional fx ran on a request for quote basis, allowing the trader to 'read' the client," says Marc Prosser, chief of marketing at FXCM, an online brokerage firm that caters for private clients and medium-sized hedge funds. "Small to medium-sized corporations and hedge funds have traditionally had a difficult time receiving foreign exchange credit lines. However, e-fx has turned this model on its head. The ability of firms like FXCM to provide margin trading based on a small amount of collateral rather than credit has greatly increased the number of liquidity options available to these participants." Without competition, there was no reason for banks to offer tight or transparent pricing to their smaller customers. "E-trading allowed clients access to two-way prices simultaneously before the client said if they



Gain Capital's Mark Galant

were going long or short – that has been a revolution," Prosser notes. The low start-up costs and an information shift from the market maker to client through cheap dissemination of price data has opened up fx to a lucrative market sector. Retail portals, which generally hit the market long before their multi-bank cousins, therefore offer clients a compelling offer. Mark Galant, founder and ceo of Internet-based firm, Gain Capital, which pioneered instantaneous dealing and live streaming quotes, comments, "Clients lower down the pyramid are more concerned with aggressive pricing and lower costs. These are offered by independent single dealer systems tailored to the sector." Despite these advantages, and a longer operational history than multi-bank portals, continued modest adoption means retail e-fx trading still has as much to prove as the rest of the market. □

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