profit/loss

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Winning Strategies

Profiting from eFX

The *Profit & Loss* Bank Guide to E-Services

Some industry participants estimate there are as many as 100 proprietary single-dealer eFX systems in the marketplace at the moment. So how does a corporate treasurer or investment manager decide which bank offering best suits his needs?

As we round the corner on the first wave of e-commerce development, client uptake of bank offered e-services has been reserved at best. Yet, with some predictions stating that 50% of all client FX business will be transacted online in the next three years, those banks that have got their systems to market are now enhancing their services, while others are still scrambling to launch.

Brian Maccaba, chairman of Cognotec, estimates there are approximately 75 banks "live" on the Internet at the moment, with projects underway at as many as 150 more. Of those online, he estimates that the most successful banks have moved just 10-15% of their client business online, while other banks have just shy of 3%. However, over the next two years he predicts the number of banks with e-offerings will double, with double to triple the current proportion of client business moving through these systems per bank.

E-commerce means different things to different people. To the larger banks, it means offering full scale, front to back office services covering a wide array of products, instruments, analytics and order management. But for smaller banks, it may be more important to offer basic online pricing, execution and confirmation services.

Because banks are at different stages of development and sophistication, *Profit & Loss* magazine's second "Bank Guide to E-Services" highlights the current state of play in the industry. Those banks included in the survey should not be viewed as either the best or the only providers of e-services. The survey, an update to the June 2000 report, can be found on pages 18 through 35.

The survey was sent to 50 global FX banks, 33 of which responded by press time to questions covering their online pre-trade, trade and post-trade services. The survey has been designed to highlight the different types of bank services available throughout the dealing process, in order to assist corporate treasurers and money managers in determining which banks provide the services they most require, and which may offer services they hadn't previously considered.

New Business Models

Richard Estes, head of FX e-commerce at the Bank of New York, believes that operating an online FX system requires more than just getting the technology right – it's about building a whole new business.

"Deployment of an online FX system must be an integral part of a bank's overall sales and trading business," he says. "A well-designed system will fail to attract and maintain users if any of the business processes do not operate correctly. The most successful online systems are those where all business processes are managed in concert."

Estes pinpoints marketing (sales and promotion), operations (implementation, system administration, client help desks) and systems (design, testing and support) as the three primary business processes behind any successful online system.

But it is also important to understand the processes of the clients, he says. "If an e-commerce system changes they way a client is used to doing things, acceptance will be very low. Therefore, any online system must automate and improve the efficiency of what the client already does," says Estes. "So first you must determine your client's needs – whether price discovery or execution is more important to them – or in fact, whether it is the backend processing that is of most concern."

Simon Wilson-Taylor, senior vice president and head of State Street's Global Link, adds, "The motivation behind the more than 100 bank systems in the market is to get small deals away from the dealing desk, because they are expensive to maintain. So, by creating an internal pricing engine that automatically applies spreads, banks can eliminate some of the more time consuming aspects. This is useful for the bank, but not necessarily for the client, because now the client is doing all the deal entry that the bank was previously doing. So you must offer clients what they want, and that is – a range of banks providers, full STP, aggregated dealing requirements, online confirmations and integration with other processes."

Steve Smit, head of State Street's Global Link, Europe, agrees that business processes must be re-engineered. "Taking the whole process – from idea generation through to settlement – to four clicks of a mouse – is where the world is heading," he says.

Pre-Trade

Many sell-side institutions are banking on the perception that clients will pay for research, advice and information that helps them navigate the markets and make trading decisions.

Pre-trade services range from basic bank-supplied market commentary, to complex charting, flow and volatility data. The delivery of research and commentary is beginning to reach a level of individual customisation. Some banks are beginning to provide tailored services – sending out only what a particular client is interested in receiving.

From our survey, it appears that most banks offer basic fundamental and technical analysis; however, provision of more sophisticated analytics varies widely from bank to bank.

State Street, for example, is known for its comprehensive research and charting services, including an extensive set of portfolio flow indicators.

Trade

Trade services encompass execution, liquidity and market access. Spot, forwards and swaps are widely available on most proprietary bank platforms, with other products such as FRAs, NDFs, EFPs and options still in development at quite a few banks. The average deal size among those that provided an answer appears to be for small amounts, ranging between $150,000 to $5 million.

FX Execution Times and Transparency Ratings

Pricing Method	Phone	Online RFQ	Reverse Auction	Streaming Quotes
Seconds	10-45	10-30	25-60	1-2
Level of Transparency	Low	Low/Med	Medium	High

**Source: Gain Capital*

Mark Galant, CEO of online margin broker, Gain Capital, identifies the four main pricing mechanisms that have emerged for online dealing:

RFQ – Client requests a quote for a transaction, the dealer responds with a quote and the client selects a counterparty and deals. Currently used by the majority of single-dealer platforms.

"The RFQ model does not provide competitive quoting to ensure best price, and the possibility exists to 'shade' or 'read' a client's position before submitting a quote," says Galant.

Buy-Side Matching – Similar to an ECN. A third party disintermediates the traditional client-dealer relationship. The user base provides liquidity to the system. All bids/offers are posted, allowing users to view depth of market.

"In this scenario, users trade directly on each other's prices, offering improved price transparency over phone-based trading and the RFQ model. However, any improvement in pricing is overshadowed by liquidity issues," says Galant. "Most existing matching systems are forced to interject liquidity. Despite the improvement in pricing, matching systems will not be successful until they are able to attract a critical mass of users."

Reverse Auction – Based on the RFQ model. Used by multi-dealer platforms – client requests a quote, multiple banks submit competing quotes within 25-30 seconds. The client then has about five seconds to select a counterparty and deal.

"This offers a moderate improvement in price transparency," says Galant. "Although there is no substantial improvement in execution time. Price movement during that time can cost clients valuable pips and compromise cost savings. And again, the possibility exists to 'shade or 'read' a client's position. Competitive pricing is directly related to the number of quotes a client receives – and this is determined by the number of credit relationships maintained by the client. Less competition can result in less aggressive quotes."

Streaming Real-Time Quotes – Currently used by a minority of single-dealer systems. Dealers continuously publish live, two-way quotes via the Internet or a virtual private network (VPN). Clients can hit the current bid or lift the current offer and execute a trade.

"Streaming, real-time quotes are second generation eFX offerings. They are already available to market participants and achieve the highest level of price transparency over other available models," says Galant. "Streaming, real-time quotes are likely to become the market standard pricing mechanism as eFX offerings mature."

To date, only a handful of banks have managed to achieve streaming, real-time "click & deal" prices. Among these are believed to be Goldman Sachs, JP Morgan Chase, Dresdner Kleinwort Wasserstein (DrKW), Bank of America and UBS Warburg.

"The provision of real-time prices, whether indicative or tradable is a great way to keep the client's attention on your offering," says Jas Singh, director of AVT Technologies. "In interbank speak, people often talk about how to make websites 'sticky'. Real-time prices are about as 'sticky' as it comes."

Post Trade

Straight-through processing (STP) is a loosely used term in the financial markets.

Many institutions may say they offer STP capabilities, but only a handful can say they offer "true" STP on the client side.

Allan McKenzie, head of business development for global FX at DrKW, believes that to achieve real STP, systems integration must "apply equally across all contracting entities, which requires unprecedented levels of co-operation."

"STP is the complete transaction process for all parties – from a single point of entry," he says. "It means only one workflow per asset class; the same front and back office systems in all locations; maximum utilisation of existing infrastructure and development work (economies of scale); and minimised operational risk (because it provides a single, global overview of risk from one system and standardises P&L reporting in every trading centre)."

At this point in time, there are only a limited number of STP solutions in the market; however, some industry participants believe that soon, no-touch electronic processing will be a hurdle which all banks must clear to remain in the business.

The incentives to conduct electronic business are primarily speed, cost and efficiency – for all parties to the transaction. End-to-end (e2e) STP is the holy grail, because only when true e2e STP is implemented will the full benefits of any e-business be truly realised," says AVT's Singh.

BNY was a pioneer in this area with the launch of iFX Manager in 1999. "Client side integration is key. If the client has some type of systems integration into a platform, whether it's single bank or a multibank platform, that is extremely sticky. Unless the FX providers are poor in their service or their pricing, the client is not going to dislodge the platform, because integration does require some commitment. Once they make a commitment, they are going to be wedded there for the medium term," says BNY's Estes.

Portals

While a few of the more advanced banks say they have now largely completed their proprietary investments, having built the infrastructure, marketing and support frameworks for their online FX systems, the next step is to enhance existing offerings and look at cross marketing potential.

DrKW's McKenzie believes the end game is integration with other asset classes that have FX requirements, such as equities.

Several banks have already begun building horizontal platforms, so clients can access different market divisions via a bank's single proprietary site. Goldman Sachs International says that of the 500 new users on its WebET platform, as much as 85-90% of these are new clients to the FX division.

The increasing number of single dealer eFX systems have prompted clients to demand a single Internet portal through which to access all of their relationships, says Phil Weisberg, CEO of the multi-contributor portal, FXall. "Clients see eFX as a way to increase transparency, functionality and convenience and have therefore welcomed new initiatives, but have not demonstrated unusually high demand," he says. "Bank and client reluctance to adopt a single, bank owned and controlled eFX platform has been the genesis for multi-bank platforms."

As banks face the upwardly spiralling costs associated with building proprietary systems, not to mention the interfaces with the portals, many are confronted with the question of whether to continue building their own systems or abandon these plans in favour of participation in a multibank initiative. Most industry leaders in this space say you must have both, because of differing client requirements.

"The majority of clients will not use a single bank system from a liquidity standpoint. They want a single portal to access many providers," says Estes. "But participation in a multi-bank platform is no substitute for a lack of a proprietary FX Web site. Simply signing up to a multi-bank platform when you haven't developed your own corporate ability is not prudent. The best model really is to focus on developing the core pricing/execution capability and then leveraging that to link to other platforms. This way you can hedge your bets, because it provides you with an opportunity to access your clients through additional channels."

"If you are an FX provider who has some business with investment managers, some with corporates and some with middle market clients, you will find that the needs of those clients are quite different. And it's very difficult to come up with one solution that's going to fit all those needs," he adds.

"Over the next couple of years, we are going to be seeing an investment hurdle by banks. Not only will their single bank systems need to be able to link to any multi-bank platform, but they will also have to link all of this to their front and back office systems," he says. ■