

e-FX

The Internet Challenge

Price Discovery

Why Price Transparency Is The Way Forward

Will e-FX improve price transparency for the buy-side? Mark Galant, chief executive officer and founder of GAIN Capital, reports on where we stand

Bank customers have long demanded greater price transparency and more efficient execution and settlement from their forex dealers. In response, a plethora of online trading platforms have recently launched or been announced, all with promises of revolutionising the currency markets.

There are single-dealer platforms, multi-dealer platforms and matching systems — from both bank providers and non-bank providers — which means an array of methods for pricing and executing deals over the internet.

The challenge for the buy-side is to decide which type of platform will best meet their needs.

To be sure, almost any online forex initiative will improve the dealing process over phone-based dealing in terms of execution and settlement.

However, the issue of price transparency is not as clear-cut. At least for now, it seems that control remains in the hands of the liquidity providers.

The multi-dealer platforms have certainly

received the most press attention, but achieve the least in terms of improving price transparency. The existing platforms employ a reverse auction model, as will the bank consortia when they launch later in 2001.

Now, instead of two or three people phoning three banks simultaneously to request a quote for a transaction, one person submits a single request for quote online, and in about 30 seconds several banks submit competing quotes for that trade. The client then has approximately five seconds to select a counterpart and complete the transaction.

This process is decidedly more efficient than phone-based dealing, but still requires several steps on the client's part and takes anywhere from 25 seconds to over one minute to execute a transaction. With rates changing upwards of 20 times a minute, this time delay can compromise any cost savings realised by the reverse auction process.

Price movement during the time it takes to complete a transaction can end up costing the customer valuable pips. Also, customers typically receive one-sided quotes on the

multi-dealer platforms. A one-sided quote makes it difficult to determine if the price received is close to the “inside” market, and is a substantial barrier to price transparency.

The fact that customers must maintain credit relationships with individual liquidity providers also influences the level of price transparency received in a multi-dealer environment. The largest buy-side clients have the wherewithal to maintain up to a dozen or more credit relationships. Their ability to request a larger number of quotes for their FX business results in more competitive quotes from the liquidity providers, who know they are bidding against several other banks.

For these customers, the improvement in pricing may offset the problem of slower execution. However, it is likely that most buy-side customers will be limited to a handful of credit relationships. A firm with only a few credit lines will receive quotes from only those few liquidity providers. And when the bank-led initiatives launch in 2001, the liquidity providers will be split among the various multi-dealer offerings,

meaning sometimes there might only be one or two providers making prices on any one quote. Overall, less competition results in less aggressive quotes.

Another important point to consider when using a multi-dealer platform is that in exchange for any actual cost savings realised through more competitive pricing and a streamlined settlement process, clients must pay a monthly fee and either a per-transaction fee or a percentage of the value of the transaction. As such, only the largest buy-side firms will achieve economies of scale through the multi-dealer platforms.

In contrast, single-dealer platforms link clients directly to a bank or non-bank liquidity provider. Most banks with any significant forex client business have either launched or are in the midst of developing a proprietary offering, while simultaneously co-operating with one (or sometimes more than one) of the multi-dealer platforms.

Single-dealer platforms approach pricing in a myriad of ways. Some operate on a request-for-quote basis. Others are further along the curve, providing streaming real-time quotes and allowing their clients to deal directly from the published quotes.

Here again, there are a variety of implementations. Of those that do offer real-time quotes, many do not consistently offer the tight dealing spreads found in the interbank market, or are designed to allow

the liquidity source to show different quotes to different customers.

Some platforms require clients to log in to different desks in different time zones, which is both time-consuming and confusing. Others do not offer the ability to leave orders or provide real-time position management or reporting.

Matching systems, another e-FX concept, claim price transparency as one of their major benefits. Following the interbank's EBS model, these platforms allow buy-side firms to provide their own liquidity to the system, by trading directly on each other's prices. They are designed to post all real-time bids and offers so users can see the depth of the market.

However, the liquidity issues of a matching system overshadow any improvement in pricing. The success of this type of platform is dependent on a critical mass of traders on the system. Without it, liquidity is not guaranteed. Most matching systems interject their own liquidity to eliminate that problem, which disproves the concept.

It seems unlikely that the matching systems will be successful until the vast majority of FX transactions are conducted online. At that point, it will be easier to attract enough users to the system in order to overcome the liquidity issue.

Essentially, the ability to deal directly from live, streaming quotes is the only path

to true price transparency in the forex markets.

When liquidity sources offer instantaneous execution from live two-way prices and allow clients to deal on them, you can be certain that the available prices are right on the market. Otherwise, the risk to the market-maker is too high, as they would immediately be arbitrated by customers with independent rate feeds.

Dealing from live quotes also offers clients the advantage of anonymity and faster execution. Anonymity precludes the price-shading inherent in request for quote pricing. Faster execution is achieved by eliminating all the steps associated with the request-for-quote process.

To be sure, price transparency is just one consideration when choosing an online FX platform. Ease of use, efficiency and straight-through processing are other aspects to consider.

But it's important to remember that e-FX is still in its infancy, and the full benefits of electronic trading have not yet been realised.

Just as with other financial markets, the adoption of electronic trading will eventually bring greater price transparency to the forex market. And because instantaneous dealing from live two-way quotes best achieves true price transparency, it's likely to become the standard pricing mechanism for the next generation of e-FX offerings. ♦