Foreign Exchange Joint Standing Committee

E-Commerce Subgroup Report

The Foreign Exchange Joint Standing Committee (FX JSC) was established in 1973, under the auspices of the Bank of England, as a forum for banks and brokers to discuss broad market issues. The membership of the Committee includes senior staff from many of the major banks operating in the foreign exchange market in London and representatives from brokers, corporate users of the foreign exchange market and the Financial Services Authority. Given the importance of developments in e-commerce for the structure of the foreign exchange market, the FX JSC decided to set up a subgroup of experts from this field to advise it. This is the third of a series of annual reports produced by this subgroup.

DEVELOPMENTS IN ELECTRONIC PLATFORMS

At the time of our report last year, the market's attention was clearly on multi-bank portals following the closure of Atriax. Multi-bank portals were able to offer STP and were advancing in providing new functionality for customers. Proprietary bank systems were being used to support pricing into the multi-bank portals but were not seen as competitive in their targeted market sector.

In 2003, proprietary bank systems have been back in focus again. Banks are focusing upon targeting flows through prime brokerage, white labeling and liquidity-exchange models, and proprietary systems are central to these models. Banks that have aggressively marketed their proprietary platforms reported to the subgroup that they saw much higher volumes across these platforms, than through their participation in the multi-bank portals. A common trend for all banks is that e-commerce volumes are growing.

Proprietary systems can also offer more tailored and integrated services. Many foreign exchange trades are a bi-product of another transaction such as a payment to a foreign supplier or foreign currency security purchase. If a foreign exchange trade can be integrated into this process then the convenience factor can play in favour of the proprietary bank system.

Multi-bank portals

The market leaders are still FXall, Currenex and FXConnect. FXall and Currenex have tended to attract corporate customers whereas FXConnect has tended to attract fund manager clients. However, all are looking to expand their customer base into other sectors, increasing competition between the portals.

The daily volumes through these portals are estimated to have risen rapidly from $7bn per day in May 2002 to $14bn per day by October 2002 according to one survey[1] and anecdotal evidence suggests that volumes have continued to grow into 2003. However in the same survey it is estimated that trading over multi-bank portals only accounts for 7% of the wholesale foreign exchange market.[2] As a comparison, the April 2001 BIS Triennial foreign exchange survey[3] estimated total daily average foreign exchange turnover at almost $1.2 trillion. The subgroup believes there is evidence that banks may be more willing to provide liquidity through a variety of multi-bank portals than a year ago.

- FXall reported that its average daily trading volumes were $7.5bn in April 2003.[4]
- FXConnect reported that it averaged $10bn per day in April 2003[5]
- Currenex do not release trading figures, although third party estimates suggest the average daily trading volume is between $4.5bn and $6.5bn.

There are geographical differences in foreign exchange e-trading take-up. In Europe and the Americas, 35% of larger organisations (defined as those that trade more than $2.5 billion in a year) trade foreign exchange electronically, while only 25% of such organisations in Japan do.[6]

The multi-bank portals are seen by some as pricing and connectivity utilities with the banks picking up the vast majority of the transaction costs, as well as a significant proportion of the initial investment capital. All platforms face the challenge of making the pricing model more equitable to both parties and may seek to achieve this through product innovation and the addition of value added services.

A new development is end-user to end-user matching systems, such as Hotspot FXi. These enable customers to post bids and offers anonymously, as well as to hit market prices. Banks provide liquidity by making prices but are unable to take prices. This model is primarily attractive to hedge funds and professional foreign exchange trading entities. As yet no one is offering a full market based model where customers can post bids and offers and banks can trade both customer and bank prices. The subgroup thinks it is inevitable that this type of model will evolve.

The multi-bank portals have strong brand names and may expand into other Treasury related businesses. The subgroup believes that it is likely that there will be further consolidation or withdrawal from the multi-bank portal business at some point, and that further consolidation is unlikely to cause any disruption in the markets. In fact it would strengthen the position of the remaining portals given that uncertainty still exists in the market, particularly following the closure of Atriax.

PRIME BROKERAGE

This is an arrangement under which a client's (often an institutional fund or a hedge fund) foreign exchange deals are cleared through a single counterparty (the prime broker). The prime broker is usually a large, highly rated 'money centre' institution which allows the fund to initiate trades, subject to credit limits and collateralisation, with a group of pre-determined third party banks in the prime broker's name, not in the client's name. These third party banks are skewed towards those of a higher credit quality but are limited in number. An attraction for the prime broker is that the business provides a stream of fee income in return for use of its balance sheet and credit assessment facilities, which it may view largely as fixed costs. The third party may also welcome the prime brokerage arrangement because it enables them in effect to accept the fund's business without having to incur credit risk to it – only to the prime broker. Prime brokerage also allows for a reduction of operational risk for the client because all its positions are with the prime broker.

The leveraged fund community makes widespread use of prime brokerage accounts, but there are a few examples of other institutions such as corporates and small banks doing so too. At present, prime brokerage accounts are much more common in the US than in Europe, but some market participants report that they expect the practice to grow in Europe if the number of leveraged funds based there continues to increase.

Provision of liquidity and provision of credit are becoming two distinct services within the foreign exchange market. Competition has already put significant downward pressure on the fees charged for foreign exchange prime brokerage and as this trend continues banks may feel pressured to increase their exposure to more risky names, particularly in the hedge fund sector. Customers often have multiple prime brokers and it is becoming more difficult for a bank to monitor a customer's overall exposure. Banks are mitigating these risks to some extent through margin accounts and improved technology. This enables them to manage cross-product risk, cross-product netting and margins more effectively.

WHITE-LABELING AND OUTSOURCING

White labeling is the outsourcing of liquidity provision by a bank to a third party through an e-commerce platform. The customer deals with their relationship bank (hereafter referred to as the 'white label' bank) via an e-commerce system and a back-to-back deal is automatically generated between the white label bank and the third party bank ('the liquidity provider') to pass the foreign exchange risk to the latter and banks.

For the liquidity provider, the attractions of white labeling are the ability to attract greater trade volumes, achieve economies of scale for their middle and back offices, and gain an information advantage through the increased flow they see (even if they do not know the identity of the originator). For the white label bank, the advantages are it receives a branded e-portal system for their clients, without the associated set up and ongoing support costs.

The subgroup felt that if the trend towards outsourcing continued there was a risk that many participants might become dependent on a few liquidity and technology providers. A break in service could impact a large section of the foreign exchange market and institutions would find it difficult to revert to a manual service having reduced staff numbers. In the longer term, a reduction in the number of wholesale providers could potentially lead to a widening of spreads.

[1] Source – Client Knowledge, quoted in FXWeek 'Online FX: a revolution in the making,' 25 November 2002.

[2] Source – ClientKnowledge, quoted in FXWeek 'Multi-bank portals fight for viability,' 25 November 2002.

[3] The Bank for International Settlements Triennial Survey of Foreign Exchange and Over-The-Counter Derivative markets; April 2001.

AUTOPRICING

One key issue for any bank providing electronic trading systems for their clients is the ability to provide immediate and simultaneous prices for, potentially, many different distribution outlets. Automation of foreign exchange pricing – 'autopricing' – allows for more timely servicing of customers, while reducing costs. This can make the servicing of smaller ticket sizes economic and increase trade volumes, without affecting headcount.

An autoprice engine is used to generate these prices, and it uses a variety of inputs. It needs to know what the current market price is, and whether the bank wants to take a view on that exchange rate. The market price information is based on a number of external sources – brokers, traders etc. It must be able to aggregate existing deal flow within the bank plus any internal flow the bank may know about. Price construction therefore depends on information about the depth of the market, as well as (credit) information specific to the individual client. An algorithm then processes all these inputs to generate a tradable rate, without dealer intervention.

However the subgroup identified a number of risks associated with autopricing. These are:

- Many institutions are dependent upon the same sources of external price information, e.g. those provided by Reuters and EBS. What preparations have institutions made if these sources become unavailable?

- A key risk with autopricing is latency – how quickly can your autoprice engine respond to market events? Or can the price be out of date, exposing you to market risk? The subgroup also noted that some clients might be arbitraging the different rates – trading one portal against another to take advantage of latent rates.

- What happens in illiquid or volatile markets? There are examples where institutions have had to end autopricing of currencies because of volatility in the foreign exchange market.

- Many customers were seeking to increase the deal size they can trade automatically – the larger the deal size, the greater the potential for loss if pricing is inaccurate. Some banks are setting limits as to how much any quote is good for.

- Another risk is acceptance by a number of institutions of a generated price. In this scenario would the bank accept all the transactions, or reject some? Does this lead to reputational risk?

[4] Source FXWeek – 'Multi-bank platforms reap e-forex growth rewards' 21 April 2003, and interviews therein.

[5] Source - FXWeek – 'Multi-bank platforms reap e-forex growth rewards' 21 April 2003, and interview with Mark Warms, Chief Marketing Officer for FXall.

[6] Source - FXWeek – 'Multi-bank platforms reap e-forex growth rewards' 21 April 2003, and interview with Simon Wilson –Taylor, head of State Street's Global Link portal, which hosts FXConnect.

CONSOLIDATION

The foreign exchange market has been consolidating over the past decade as a result of bank mergers, centralisation of trading operations, and the launch of the euro. The subgroup believes that the growth of e-commerce within foreign exchange trading could accelerate this trend through high technology costs, margin erosion and outsourcing.

Information provided by EBS to the subgroup shows that over the past two years inter-bank business between the top ten to fifteen liquidity providers has increased significantly. The subgroup believes that the number of banks able to provide liquidity in a full range of currencies may dwindle to just a handful. The largest banks are therefore seen as aggressively targeting liquidity in order to secure their place in this 'premier league.'

E-commerce has reduced the costs of processing trades, allowing banks to generate profits through trades of smaller and smaller values. Spreads are also tightening and banks need to see increased flows in order to maintain profitability. The cost of technology is now much higher and with decreasing margins, lower volumes may make outsourcing and white-labeling models more attractive to many smaller and medium sized banks, who are seen by the larger banks as customers, rather than competitors. They are also offered liquidity through both multi-bank and single bank portals.

However the subgroup felt that the trend towards consolidation raised the following risks for the foreign exchange markets:

- Larger value trades are becoming concentrated in a decreasing number of institutions. This could lead to greater volatility and more pronounced market movements, particularly around fixings, combined with greater profit and loss swings in the foreign exchange market.
- Mergers between banks occur over a number of years but outsourcing can create the same effect in a matter of weeks. Wide adoption of outsourcing could rapidly change the dynamics of the foreign exchange markets.

The buy-side are also changing their behaviour. They want fewer bank relationships and those banks need to be able to provide a wider range of services. The buy-side are also rapidly changing their sentiment towards e-commerce. They realise the benefits of this new channel particularly with STP and many now demand that their banks provide an e-commerce service. This may encourage more banks to offer prime brokerage facilities.

CONCLUSION

New technologies are resulting in rapid changes in the way the foreign exchange markets operate. Rapid change inevitably brings new challenges and new risks, but individual institutions appear able to use the same technologies to help mitigate these risks and because the market is so large and diverse, it is effectively self-regulating.

Greater automation through e-commerce is helping to reduce headcount in banks and roles within banks are changing. The subgroup noted that some sales dealers are processing a reduced number of trades and expected to focus upon customer relationship management, while traders are quoting fewer prices and instead managing flows, particularly around fixings.

The psychology of the foreign exchange market is also changing. The increase in price transparency that e-commerce brings has ended the aggressive trading style seen particularly in the late eighties. Banks are communicating and cooperating more, particularly on infrastructure, technology and e-commerce standards. This price transparency may have contributed to the margin erosion reportedly experienced by all banks.

Overall, the subgroup concluded that:

- There is likely to be further consolidation or withdrawal from the multi-bank portal business at some point, but the impact of this to be limited.
- There is a significant level of competition in the eFX market place, and customers are the main beneficiaries from this, as banks are funding the investment into electronic market place infrastructure.
- Provision of liquidity and provision of credit are becoming two distinct services within the foreign exchange markets.
- E-commerce has reduced the costs of processing trades, allowing banks to generate profits in settling trades of smaller and smaller values.
- Larger value trades are becoming concentrated in a decreasing number of institutions. This could lead to greater volatility and more pronounced market movements.
- The increasing use of autopricing of dealable foreign exchange rates, without dealer intervention, increases the reliance upon, and importance of electronic trading systems.