FX trading on the web – how, when and why

Like most sectors of the economy, FX trading is diving headfirst into e-commerce. Chris Cooper of ANZ considers the price of FX trading on the web.

In the headlong dash to embrace e-commerce, banks are rushing to migrate foreign exchange price execution businesses to the web. As corporate clients push for cost savings in this rapidly developing global marketplace, it is important for banks to be seen as a driving force behind web trading systems and as a provider of real efficiencies via straight-through processing.

Debate on the need to improve the basis of price discovery and the use of web-based technology has been intense and well-documented. This article will not seek to reiterate these arguments, but looks beyond the current debate to consider some of the key issues confronting the corporate market, as well as at some lessons from the recent past.

Don't believe the hype

Despite the e-commerce hype, current availability of e-FX is still limited and there are relatively few systems available for customers to access and evaluate in terms of the 'live' foreign exchange market.

Corporate treasurers can expect to continue to be bombarded with offers of web-based trading applications from a variety of sources. Already becoming established are the proprietary systems developed by some of the banks to provide FX trading services direct to companies. Alongside these, various independent non-bank 'bureaux' have also set up FX pricing services from banks. Most recently the launch of the so-called 'multibank aggregated pricing portals' were announced. These will offer customers access to pricing from a core group of banks, but are still very much in their infancy.

The challenge for corporate treasurers will be to assess the right portal to suit their company's needs and to decide the optimum timing to enter the electronic market. Of course, electronic trading is old news to the foreign exchange markets and has been operating within the inter-bank environment since the 1980s. Lessons can be drawn from the inter-bank's transition to electronic commerce networks (ECNs) that raise questions about the future ownership of market risk and about costs in relation to web-based FX trading.

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Getting better all the time

To date, even the early experiences of electronic trading have clearly demonstrated the numerous gains in efficiency in terms of straight-through processing, simplicity, speed and competitiveness of price or added enhancements provided by individual banks.

However, it will be important for both banks and their customers to balance these efficiency gains against some key considerations.

Looking back at the impact of the inter-bank ECNs on the dynamics of the market, the questions for future FX electronic trading are:

- what will be the residual impact of global liquidity?
- what will drive peculiarities in price action?
- is the cost of liquidity underpriced? and
- who will pay this price in the future?

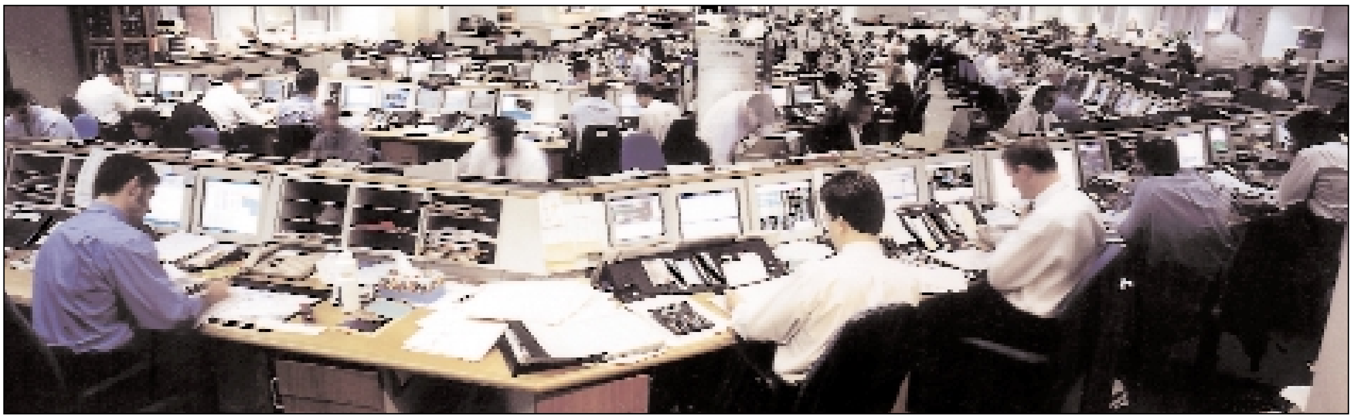
The answers to these key questions will decide who in the future will own market risk. Prior to the introduction of electronic brokers, foreign exchange markets were based around direct trading between banks or via voice brokers. A trading bank could determine the amount of liquidity available at a given time despite market volatility. In other words, there was an awareness of the depth of any market at or around the ruling price prevailing at the time.

The sum of the broker prices and the obligation of the price makers determined not only the liquidity of the market at a given time but also the spread that could be quoted to a company for both smaller and larger transactions. Bank traders could clear risk through brokers and other players in the market and so the market price and liquidity risk was, to a degree, shared by market participants. Price discovery was, therefore, linked to available liquidity in the market and price action in normal market conditions occurred at all levels within the range of the markets and between key market levels.

Currency convergence and rationalisation in the banking sector helped bring about the evolution and development of ECNs. This in turn generated changes within the inter-bank trading environment that made it increasingly difficult to judge liquidity risk. The voice broker market and direct inter-bank relationships was greatly reduced.

As a result, a high proportion of trading now occurs at key levels before markets 'gap' to the next key level with limited trading in between. This can be seen from a simple examination of price charts of currencies traded over ECNs. The 'gapping' nature of the market had become and remains more prevalent.

In today's environment, banks are assuming far greater liquidity risk than ever before. This may or may not prove profitable depending on the effectiveness



One of the benefits of e-FX is that it will greatly speed up the trading and back office processes

of risk management within individual banks. However, the issue of whether banks are being adequately compensated for assuming the increased risk previously distributed among other market-makers raises new questions. Among these is the possibility of additional costs for the customer, as well as the potential for new capital requirements on banks in terms of liquidity.

Who takes the risk?

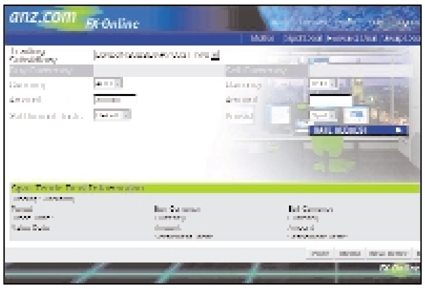
To illustrate this issue, consider the case of a corporate treasurer looking to buy a sizeable package of dollars against Japanese yen. Let us assume the amount is $200m and the deal is to be transacted through a notional e-FX portal.

How will the risk be transferred, and how will the bank or banks be adequately compensated for assuming that risk?

If a single bank does not assume the risk in totality, will the corporate treasurer be willing to pay for the lack of intermediation by the bank when he or she ultimately achieves a final but potentially inferior rate?

Further, will the treasurer be prepared to become dependent solely on the FX portals for price execution and assume the risk of unwinding the position in parcels of, up to, say, $5m in a moving market? This seems unlikely.

As the market migrates from traditional price execution to FX trading via a corporate portal, the ownership of market risk will need to be considered alongside the perceived benefits. In addition, treasurers will want to be convinced that the web-based offerings are of more benefit than direct contact with their relationship dealers in banks.



On-line focus

An offer you can't refuse

So, what are the tangible benefits, and how do they measure up against any perceived risks?

e-FX offers a number of clear attractions to treasury departments. These include real-time automated pricing and greater transparency.

Straight-through processing means that manual intervention is removed from the trading and back office processes.

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Trading is streamlined, accurate and accountable with more efficient response rates. Time and resources spent on vanilla transactions is significantly reduced. At the same time, highly sophisticated technology guarantees a totally secure trading environment.

The savings in time enable corporate treasury staff to focus on more value-added solutions for their businesses. They will also be able to take advantage of additional refinements becoming available.

Individual banks at the forefront of web-based systems are already offering a competitive range of enhancements such as web-based research and analytics.

Future developments will include the potential to link into internal treasury risk management systems, cash management systems and web-based confirmation systems.

Some treasurers may take the view that, at this stage, they just want access to more credible price information and will wait until all the new FX systems are fully developed.

Don't miss the bus

However, delay is not the solution. The benefits offered by the new technology and the potential offered by the internet indicate that early involvement in e-FX will be strategically important to most corporate treasury departments.

In the e-commerce race, 'early adopters' can easily take the advantage to gain an early understanding of and confidence in the new technology. As stated earlier, the issue of market risk must be considered, but the greater risk is being left behind! ■

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