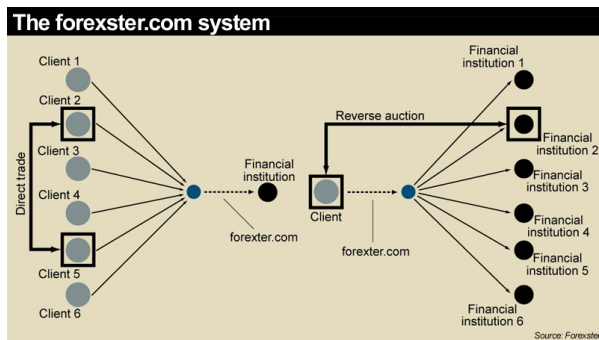


**Headline: Forex goes into future shock**Source: [Euromoney](#)

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**When forex trading first harnessed the internet, banks tried to attract clients to their individual platforms. They soon faced the problem that some customers were obliged to seek the best price for every transaction. Hence the difficult birth and troubled childhood of multi-bank platforms. End-users seem little more happy with these systems than the rival banks that set them up. And before they have had a chance to digest their implications clients are being offered the prospect of trading directly with each other. Jennifer Morris reports on a market whose innovators may have taken a step too far**



[View chart large](#)

Campbell Harvey knew he had a captive audience. Stand up in front of a group of CFOs and suggest that perhaps they're paying over the odds for foreign exchange transactions and you very quickly become the centre of attention.

"They were all nodding and saying yes, the costs are huge," recalls Harvey, whose day job is teaching finance at Duke University business school in North Carolina. "So I pointed at one of them and said 'you have e10 million to sell'. Then I turned to another and said 'you need to buy e10 million' – you

guys should be talking to each other."

It seemed obvious to Harvey and his then PhD student and now business partner Arman Glodjo that the online forex markets could do better. "The standard spread on a \$1 million euro transaction is \$500 by pips, then there are other costs, such as clearing and settlement, that add on around \$25," says Harvey. That is too high. By slimming down the banks' role to preserving credit lines and providing a clearing mechanism, he estimates that end-users could cut the cost of doing a standard \$1 million transaction in half and stand to save even more on larger deals. Over a year, the potential economies are phenomenal. And as the managers of three Bermuda-based hedge funds, Harvey and Glodjo were well aware of what that could mean.

So Forexster was born. It's an internet-based foreign exchange trading system that uses a reverse-auction mechanism – unlike FXall and Atrix, which work on the principle of request for quote. Also, in contrast to existing systems, all participants – banks, hedge funds, mutual funds, brokers or corporates – can be both price-makers and price-takers. When a treasurer or fund manager posts a trade, it is fulfilled either by one of the banks with which that institution has a credit line or by another client of one of those banks.

In the first case, the bank processes and clears the trade normally. In the second, the trade happens via the bank, which handles the clearing, even though the trade is taking place client to client. They might be customers of the same bank or one might have a relationship with another bank, in which case the financial institutions clear the trade with each other on behalf of their customers. There's a built-in safeguard that ensures that when an order is entered, only the participants that are able to fill it through their existing credit lines – which are determined by their banks – get sight of it.

The name Forexster is a deliberate play on Napster, the US-based site that enabled users to trade digital music files with each other, rather than buy CDs. Deemed to infringe the rights of the record companies, Napster has now entered the mainstream with a deal with BMG. But Glodjo says the technology is actually closer to that of Gnutella, a type of software that allows for the decentralized sharing of files. When users look for material, the search engine hops from PC to PC to find the requested file, rather than going to a central server.

In the same way, requests on Forexster are seen by the entire client base of the bank, rather than just a single institution, and all of that group can compete for them. "When a CFO posts a trade, the system performs an arbitrary number of credit hops to find the best price," explains Glodjo. Furthermore, a client trying to sell e200 million is not dependent on finding another counterparty with the exact opposite requirement. "Part of the order might be filled by a natural seller and the rest by a bank." In the worst-case situation that there is no corporate on the other side, a bank or banks

would theoretically step up for the whole amount. "If your bank is on Forexster, they should give you the same price as if you had called them up and asked for one," asserts Glodjo.

So far so good. But the devil is in the detail and the flaw in Harvey and Glodjo's plan could prove to be fatal. As they themselves point out, it is hugely profitable for banks to keep clients apart, so they will fight tooth and nail to defend the status quo. "It will eventually be forced on them by clients who really love this idea and will say to the banks 'either you come on to this system or I'll start using a bank that is'," says Harvey. But when it comes to a change they're not keen on, bankers are champions in the art of foot-dragging.



**Richard Moore**

"Clearly, banks are going to resist this, particularly those with the greatest market share who have the most to lose," says the head of foreign exchange trading at a large US fund manager. "But eventually they will have to realize that foreign exchange is more of a service than a margin business." However, it's difficult to imagine banks willingly collaborating in technology that will bring about their own disintermediation.

Many critics of client-to-client (C2C) trading comfort themselves with the thought that the difficulty of ensuring the creditworthiness of so many different counterparties will put the brakes on its development. "I think it's highly unlikely that clients will be trading with each other in the near future," says Richard Moore, head of foreign exchange at Citibank. "I just don't think

they will be prepared to invest in the necessary credit architecture." He goes on to explain that hedge funds and corporates would have to undertake the necessary credit assessment of hundreds of their peers themselves and that the difficulty of doing this would outweigh any potential benefits.

But Forexster claims to be able to eliminate the need for credit checking. The banks verify counterparties on behalf of their customers. If the system works then the party requesting a price won't even notice the difference between trading with a bank and with another client – until they see the spreads they are paying.

Some bankers maintain that lower pricing is really not that great an attraction, though, and won't necessarily entice people to use Forexster. What customers are really looking for from their foreign exchange banks is high-quality advice and efficient processing, they claim. The argument here seems to be that because they don't pay directly for these services, clients don't mind being stung on transactions.

"When foreign exchange started to move online, people thought that clients would focus on pricing," says Bill Brown, managing director in the FX division of Morgan Stanley. "But in fact they're looking for connectivity. The biggest cost is the hidden cost of errors." He maintains that C2C trading would create a huge administrative headache. "If a corporate has e100 million to sell, they are probably not going to find the other side of that transaction so they would have to take bits and bobs. They would then end up with a back-office headache as they tried to settle 30 different trades." This of course is how the EBS electronic broker system currently works: trades are broken into tranches and bought and sold by different banks.

Another commonly cited obstacle to C2C exchanges is that they simply would not attract enough liquidity to stay afloat. "All clients really care about, besides STP [straight-through processing], is being able to get in and out of positions easily," says Justin Bull, head of e-commerce at Barclays. And it is unlikely, say many critics, that there would be a sufficiently large number of participants making prices on Forexster, at least in the early stages, to create a viable market and allow this to happen.

David Woods, head of e-commerce products at ABN Amro, points out that lack of liquidity has already plagued several other C2C online exchanges, such as BondConnect by State Street. "Bond market buy-side-to-buy-side platforms didn't work. Sooner or later all of them had to bring in the sell side in order to have enough liquidity," he says.

Yet if any market has the depth to enable end-to-end trading to work successfully, it is the forex market. Bankers constantly talk about how there are vast amounts of liquidity in the market – until the conversation turns to C2C trading. Okay, so perhaps C2C bond platforms haven't really taken off but the concept is proving reasonably successful in the much smaller commercial paper market. Companies buy CP from other corporates and financial institutions with ratings that are similar to or higher than their own. It isn't a huge leap from this to spot foreign exchange.

Those whose positions in the foreign exchange market are nicely entrenched are also fond of the

argument that outsiders just don't understand what is involved. "A lot of people don't understand the infrastructure required [to run an online trading platform]," says Phil Weisberg, CEO of FXall. "The bar keeps rising, clients are demanding more functionality and faster response times and it's difficult to compete."

Others point out that CFOs and fund managers do not have the necessary skills to trade foreign exchange on both the bid and ask side of the transaction. Corporates don't like showing their hand to the market and, forex bankers warn, reckless trading might put that confidentiality at risk. "If we get \$50 million from a corporate then our traders will finesse that into the market. They will not sell it all in one go," says Roger Hawes, head of FX trading at Royal Bank of Scotland. "Clients are paying for banks' professionalism and experience." In order for a C2C trading system to work, trading rooms would have to migrate from the banks to corporates, an unlikely development.

However, the foreign exchange business undertaken by corporates only comprises a small proportion of the total volume transacted every day. Much of the trading that takes place in the foreign exchange market is done on behalf of institutional investors or hedge funds wanting to close positions. The largest already have teams of dealers and analysts in place and it would probably not take these people too long to master the complexities of trading spot foreign exchange.

Still seeking the right model

The fact that a seemingly intuitive idea meets with such universal criticism among bankers is a sure sign that they recognize a threat. Public dismissal of C2C trading is a vital part of the charade they're all playing. To concede that it might not be a bad idea could lose them their jobs.

But in private, some bankers admit that they find the idea of C2C trading "very worrying" or even "dangerous". It's not surprising. They need little reminding that the migration online of the foreign exchange business has not exactly been a resounding success.

Initially, there were the single-bank platforms. With varying degrees of success, banks developed proprietary platforms and, with varying degrees of aggression, tried to persuade their customers to use them. By doing routine transactions with us online rather than over the telephone, said the bankers, our sales team can devote more time to providing you with value-added services. An ancillary benefit of course was that this also enabled the banks to do higher volumes of business, with more clients, at a lower cost.

While we're at it, said the banks, why not integrate your back-office system with ours and harness the benefits of straight-through processing. Great idea – STP speeds up transaction time and reduces errors, meaning less work for the clients. By lucky coincidence it also saves even more of a bank's money by cutting down on administration, creating a virtuous circle of riches for everyone.

Perhaps this is fair enough and the benefits of online trading and efficiency improvements should rightly be shared among customers and the banks. But by going down the single-bank route, the banks immediately isolated some of their largest and by definition most important customers – the asset managers. Custodians of third-party money are obliged to seek out the best execution price every time they do a transaction. "We have never used these platforms and we have always made it clear that we can't use them because the regulator requires us to get the most competitive quotes," says Harriett Richmond, head of currency at JPMorgan Fleming Asset Management.



**Dieter Musielak**

It was because of pressure from managers such as Richmond that multi-bank platforms were born, but they too have failed to have much of an impact on the forex business. It's difficult to quantify precisely how successful they've been, since the platforms are refusing to disclose information about numbers of members, trading volumes or operating costs. "Tell me where the volumes and revenue flows of all our competitors are written down for everyone to see?" asks Weisberg. "The whole industry is not revealing this because foreign exchange is an over-the-counter market."

That's not a very persuasive argument. More damaging from Weisberg's point of view is that this evasiveness feeds the flames of speculation, sparked by anecdotal evidence, that Fxall, and Atrix in particular, are not doing very well. "The feedback we're getting suggests that people are generally disappointed with the multi-dealer platforms," says the head of e-commerce at one bank. "There are problems with the connectivity and functionality and the legal work is extremely time-consuming," he continues.

Hitches with technology range from the banal and easily solvable – clients using software that is

three versions older than that on which a system is configured to run – to the more fundamental, such as major gaps in functionality. Some platforms lack basic tools: FXConnect, the veteran platform, does not allow request for quotes from more than one bank simultaneously, for example. Atrix has only just installed the functionality that enables banks to provide quotes automatically rather than manually, whereas FXall had this ability at launch.

The word on the street suggests that this is not the only sense in which FXall's technology is superior to Atrix's. Several users have told Euromoney that FXall is easier to get to grips with and more intuitive than Atrix – vital given that customers have very different levels of computer expertise.

Although technical glitches may eventually be ironed out, the feeling that the banks are doing everything in their power to preserve their own market share is bound to linger. This is particularly the case with Atrix, given its concentrated ownership structure. A banker outside the circle of three says: "Those banks have had captive users for a large number of years and the prospect of those customers going elsewhere is terrifying for them." Claims another banker: "There's definitely an element of giving the client the perception of multi-bank pricing."

That's a criticism that Citibank's head of FX, Richard Moore, strongly rebuts. "How could we do that when we allow other liquidity providers onto the platform and operate a completely open platform?" he asks.

Another venture that is not yet operating but is even more starkly an attempt to guard market share is a multi-product portal dubbed Centradia to be set up by Santander Central Hispano, Commerzbank, Royal Bank of Scotland, Sanpaolo IMI and Société Générale. None of the members plays a significant role in the forex market – Royal Bank of Scotland made it to twentieth in the Euromoney foreign exchange poll this year (mainly because its takeover of NatWest absorbed that bank's share of the market) and Commerzbank thirty-eighth.

Centradia smacks of defensiveness. The platform will operate on an invitation-only basis and as yet the five banks, which have cross-shareholdings, haven't asked anyone else to join. In theory, their ownership structure should make it easier to work together but that is apparently not the case. Touted for launch in spring 2001, Centradia has not yet gone live. "We're in the final stages of testing and we're working on getting FSA [UK regulatory] authorization," managing director David Woolcock assures Euromoney. "We will launch in the last quarter of 2001 or the first quarter of 2002."

Whenever the operation goes live – Centradia is already around six months behind schedule – it is unlikely that Commerzbank will be at the launch party. According to an insider, the German bank is on the verge of quitting the platform. It is scaling back on all non-urgent IT investments and Centradia falls into the "nice but not essential" category.

Commerzbank isn't the only waverer. Though no member banks have yet pulled out of any of the major platforms, many seem to be having doubts about whether the move towards multibank portals was the right one to make. Or, if it was, whether they should have created something more radical. "With the advances in technology we've seen over the past few years, it's hard to believe that the best the banks could come up with is an automatic request for quotes," says Forexster's Glodjo.

Yet as recently as the middle of last year they were all professing their commitment to the multi-bank portals as the only way for foreign exchange to go. That attitude soon went out of fashion when the requests for second-round financing began to come in and banks' own shareholders asked them to account for all the money that had been spent. According to some reports, participants were asked to chip in around \$20 million each for one of the portals. But explanations as to where the money went are few and far between. In the meantime, some have chosen to write off the investments to their P&L, while others are holding it on the balance sheet at cost. With no true indications of how these platforms are performing it is impossible to place a market value on a stake. Who knows if one of them will go bankrupt tomorrow?

A number of banks, perhaps the majority, are now hanging back and hedging their bets against just this possibility. "We're trying to keep our clients happy while spending as little money as possible at the moment," says one head of e-commerce. Another suggests that clients are doing too well out of the multi-bank portals and that the current situation is unsustainable. "Banks can't keep a loss leader going for ever," he grumbles. Hawes at RBS adds: "We're certainly not rushing in with equity investments. Even if you're not a market maker in the first few months, you're not really going to lose anything. History means nothing, if you're the best price maker then you're going to do okay."

One or two are more optimistic. "In terms of client satisfaction, we have got value for the money we

have invested. We wouldn't expect this to have an economic impact yet, profitability has to be the success metric of the future," says Fabian Shey, head of e-commerce at UBS Warburg and president of Fxall.

And some have also responded positively to the request for further equity injections. Among them is BNP Paribas, which in September increased its stake in FXall, bucking the trend among competitors. "It was a straightforward decision," says Loic Meinel, head of foreign exchange trading at BNP Paribas. "Since FXall launched in May, it has been on-boarding clients very rapidly and the volumes being traded by clients that are live on the platform is much bigger than was expected previously."

Meinel declines to reveal what proportion of BNP Paribas' foreign exchange business is being done over FXall. It's difficult to say because of the different segments into which the forex business is divided, he explains. He does state that the volumes are multiplying every month, however. Despite all the bad press, "we believe that online execution will be the norm for at least half our FX business within two or three years," he says.

Next step an exchange?

This could be a risky strategy, though. It's unlikely that all of today's platforms are going to survive and having to explain to company directors why all of the bank's eggs were in the wrong basket is not a prospect many heads of e-commerce will relish. "It's a bit like the early days of videos and the battle between VHS and Betamax," says Zar Amrolia at Goldman Sachs. "It's early days and no-one really knows which one will win in the end."

That's to assume, though, that the winning model will look anything like what is around today. "What do the consortia really offer?" asks the head of e-commerce at one bank. "Quotes over the internet have no real advantage on telephone, prices are tighter than ever and brokerage fees greater than ever. When you've discounted all the benefits it really comes down to being a credit issue."

Because of this, greater price transparency and the nature of foreign exchange – the product doesn't have to be pushed out to customers, they want to be in the market regardless – a move towards an exchange makes a lot of sense. And there are signs that it might not be a million miles away. Over the past five or 10 years, the concept of banks trading their own book has been slowly but surely receding. Taking on risk positions is not a popular strategy because banks don't like losing money – particularly not their own. It's far safer to earn returns doing transactions for clients and providing payment and settlement. In an exchange-type model, banks would be paid a fee for these services, instead of charging spreads on each transaction.

Some market participants have now tacitly accepted that foreign exchange will not be a margin business for all that much longer. A number of heads of foreign exchange sales are bowing to demand and have agreed to provide customers with spread-free prices – that is, the rates they themselves pay in the interbank market. They can justify this apparently because of the revenue gleaned from a customer in other areas. "Our policy is that our prices should on average be as good as the best in the market. If a client was doing a lot of options business with us and had relationships across a number of different FX products then we would make a business judgement based on that," explains Geoff Grant at Goldman Sachs.

He isn't alone in this. Letting clients see rates quoted on the EBS electronic broker system is officially frowned upon, "it is a breach of convention, but if the client is important enough then it will happen," says Woods at ABN Amro. Banks are under huge pressure to do this, from hedge funds in particular. These take umbrage at their banks' policy of slapping a huge spread on every trade. "We're providing very aggressive pricing to all our key clients," says Citibank's Moore, who adds that it is no longer unusual or unethical for banks to do transactions at interbank prices.

With banks already acting more like clearing houses and price discovery becoming an outdated concept, Harvey and Glodjo's model may be yet another step along the road to acceptance of the exchange model – if banks can be persuaded to embrace wholeheartedly the new role they have begun to adopt in the foreign exchange markets.

The multi-bank portals insist that they won't be left behind. They are ahead



of the curve and open to end-users getting involved on the price-making side too. "Customers can trade with each other on FXall," says Weisberg, adding that none has yet moved this way. "The main reason for this is simple, customers tend to focus on their core business."

Karen Steele, vice-president global marketing at Currenex, says: "Our philosophy is that if clients have the relationships and the credit in place and they want to do this, we would not stand in their way but we've not heard any desire from our member base to do this."

### Campbell Harvey

Neither FXall nor Atrix can claim to have created an open-to-all, exchange-like platform, however. Barriers to entry for market makers are high, involving a hefty equity stake. That could change if one of these portals were to become so successful that the UK's Financial Services Authority or the US Securities & Exchange Commission stepped in and insisted on its becoming a regulated market.

This was the case with Australian bond platform yieldbroker.com, sponsored by Citigroup, Deutsche Bank, UBS Warburg and Westpac, which was launched in June 2000. Although the four founders provided liquidity initially, the site was only able to gain regulatory approval because it was open to all market makers in Australia and New Zealand – in practice as well as in theory. Though participants have to make an equity investment, this is sufficiently low as to mean that the site is not exclusive.

Might the same thing happen here? Opinion is divided. "These platforms will eventually be forced to be utilities," says one banker. "I think that the utility model works and that regulators will prevent them from being anything else." However, there are a number of issues to be resolved before this can happen. The size of contracts is a tricky issue – an exchange would require a standard size that is neither too large to exclude the smaller players nor so small that it failed to be cost-effective.

Another impediment is the fact that the formation of an exchange is politically charged. It makes sense for US equities to be traded on a US exchange and European equities in Europe. US end users and market makers would have little incentive to support a US-based exchange, however, and vice-versa.

"We are committed to working with the regulators," says FXall's Phil Weisberg when asked to comment on this prospect. "Whether we will end up with an exchange, the jury's still out."

But while he and his peers are making up their minds about this, Forexster is waiting eagerly in the wings with what could be a precursor to an exchange. According to Glodjo, the product has been perfected, testing is complete and he and Harvey have won copyright for their reverse auction secure transaction architecture (RASTA). The pair have also hired advertising agency Saatchi and Saatchi to give Forexster extra kudos. There's just one thing missing – liquidity providers.

Glodjo and Harvey maintain that they are on the verge of signing an agreement with a major US investment bank. They're not revealing the identity of this institution but Glodjo claims to have demonstrated Forexster to, among others, Citigroup, Deutsche Bank, JPMorgan, Bank of America, Morgan Stanley, HSBC, ABN Amro and BNP Paribas.

If and when that contract is signed, will it prove to be the catalyst that Forexster's founders have been waiting for? "They only need a small niche to begin with," says one institutional investor. "When users start to see lower prices on Forexster than their bank is offering they will ask themselves whether they shouldn't be a part of it. And liquidity grows on itself." However, with the largest banks proving resistant to the idea, the first wave of members are likely to be second- and third-tier banks with little market share to lose. Their presence alone may not be enough to kickstart the platform.

The largest banks will probably hold back for as long as possible, not least because they have a duty to provide returns on capital for their shareholders. Heads of foreign exchange will be keen to avoid getting into a debate similar to the one currently raging between their colleagues in syndicated lending and bank credit officers. They'll want to know what business accrues from charging clients for taking on credit risk.

It also remains to be seen whether, beyond the initial flush of interest, corporates really want to see this change. "Sometimes you have to react very quickly and you can't wait for someone to match your transaction," says Dieter Musielak, head of financial services at Siemens. "And besides, we are not designed to take currency risk."

## The quest for liquidity

Of course he and many of his peers would like to pay less for foreign exchange, Musielak says, but not if this results in reduced liquidity. On the other hand, for many CFOs and fund managers – such as the group Harvey talked to – the prospect of saving even just a few pips on each foreign exchange transaction is going to be extremely attractive.

“I would be in favour of [an exchange-type model] if I believed it would lead to lower transaction costs for clients,” says Richmond at JP Morgan Fleming Asset Management. “But you have to remember that the currency market thrives because it is an OTC market and is therefore so adaptable.”

Corporates and fund managers may just turn out to have neither the inclination, nor the resources, to trade foreign exchange themselves. It demands a very different mindset and, at a time when so much treasury business is being outsourced, why bring a function that has until now been performed externally in-house? “E-business is incredibly time-consuming,” admits Musielak.

What’s crucial for Forexster is to on-board the hedge funds as quickly as possible. This is because they are the most regular users of foreign exchange, and so hedge fund managers are likely to be most enthusiastic about the cost savings and less wary of trading independently than corporates. Furthermore, the ability to be a market maker and not just a price-taker opens up a whole new avenue of arbitrage opportunities.

But they’re not going to do this until there’s a guarantee of liquidity and Forexster may not be able to provide this soon enough to safeguard its future. Conceptually it can survive without the banks’ involvement but its lifespan as such would be severely restricted. Unless it recruits liquidity providers in time then, ironically, the portal will become a victim of its founders’ innovation. It’s an intuitively appealing idea, but arguably the product has been born too soon.

“I’d certainly give them no better than a fifty-fifty chance,” says one fund manager. For hardly have end users had a chance to get to grips with the idea of trading foreign exchange online, then they’re already being asked to go one step further and trade with each other.

Eventually it will happen – all the signs are pointing to the market moving towards C2C trading. It’s the natural end-game for all financial markets simply because it is the most efficient format. And clients will demand that efficiency. But, though the final result may look like Forexster, the chances of it actually being Forexster are probably slim.

