Unlocking the C2C forex riddle

If turkeys aren't going to vote for Christmas, they are certainly not going to pay for it. That's why online client-to-client trading in foreign exchange has traditionally been ruled out. Banks wouldn't support it, and the complexities of setting up credit lines between end users on a platform would kill it anyway. But client-to-client trading still seems inevitable, and now a hedge fund manager and a finance professor have worked out a way of doing it, without missing out the banks and without credit problems. Multibank sites beware. Ben Wright reports.

At first, Arman Glodjo and Campbell Harvey, who run three hedge funds in Bermuda, believed the hype. Like any other foreign exchange client, they had been told that trading had been through an online revolution, with multibank platforms bringing new and exciting ways of doing business. So they looked to the internet to find efficient trade execution.

"What I found was a shock," says Glodjo. "It seemed to me that all the different portals had missed a chance. Why were the banks not leveraging the technology of the internet when they obviously knew what could be done? The answer is their revenues. They were pulling the wool over the eyes of their clients."

The shock for Glodjo was that the internet is still unable to offer client-to-client trading. Although FXall and Atriax have launched live public trading, they still rely on the bank in the middle of the trade, and the banks still make their money out of spreads and transaction fees. But in theory the internet allows buy-side clients to trade among each other without those big spreads.

It is a tried and tested model, although Napster, its best example, exists outside finance. Napster allows music fans to exchange files over the internet rather than buying CDs, much to the annoyance of music companies. Following that model, Glodjo and Harvey set up Forexster, a deliberate play on the Napster name, and they hope to launch in August this year and shake up the FX industry in the same way.

What they are proposing is completely different from the models used by the main online trading portals - FXall, Atriax and Currenex. Forexster argues that the banks have used the new portals to retain their old business models and avoid disintermediation, to the detriment of clients.

Banks are so worried about the prospect of disintermediation, that very few bankers are prepared to go on the record when discussing even the concept. Says one of the venture capitalists behind Forexster: "Every bank we have talked to say they have never heard of direct c-to-c in the forex market and it scares them all." One banker, whose institution is in discussions with Forexster, asked to be phoned on a Sunday, on his mobile, on a golf course, before he would speak freely.

Forexster says this fear of disintermediation is why new online platforms have replicated the old FX profit model. Says Campbell Harvey "We have seen these companies offer something, but basically what they are doing is not much different from the way that the market has always been structured. It is a move to protect bank spreads. What FXall and Atriax are offering, in my opinion, is probably not sustainable because it doesn't address the fundamental issue that the cost of trading is unreasonably high."

A Napster for forex

Existing platforms work on the same principle as when clients phone banks to get quotes. "I don't see that there is any particular advantage of an internet request for quote over the telephone," says the banker who is in talks with Forexster. "I view it as an interim model."

The Forexster system consists of two different types of trading units. One allows a client to request prices from all the member banks that it has credit relationships with. The second unit can be set up by a bank to allow its entire client base to trade with each other.

In a type-1 trade, a client, who has credit lines with a
number of member banks, can use Forexster to post a price in a reverse auction. This is simultaneously seen by all the banks, which compete for the order, in a standard bank-to-client transaction. But the innovation is in the type-2 relationship, where a bank gives its clients the ability to trade between with each other. This client-to-client model has up to now been rejected. Says Mark Warms, chief marketing officer at FXall: "For client-to-client trading to work you would need literally thousands of lines of credit between all the different possible counterparties to allow them to trade with each other. It is going to be very difficult for people to trust that kind of model."

But Forexster does something slightly different, avoiding a centralized exchange. Rather than clients taking on credit risk for the other side of the transaction, trades pass through the credit lines that each client already has with member banks. And the limit order book works in such a way that clients see only orders that they have the ability to fill through their existing credit lines. It does not matter how many stages a transaction has to go through, as all trades are routed through the best available channels of credit. So theoretically at least, a trade should never fail because of credit problems. And everyone can be a liquidity provider.

Many hurdles to jump
So far, so good, but the online trading platforms that have so far launched claim that they have not seen the demand for these kinds of trades. "We don't label or brand any of our clients and so they can all trade with each other," says a spokesman for Atriax. "But it remains to be seen whether the traditional buy-side has the appetite to be price-makers."

Sceptics also say that Forexster has taken a chance with the reverse auction model. "I think that the reason a reverse auction model wouldn't work in this market, is because of the public nature of it," explains Warms at FXall. "The first thing that a trader will do when he sees a big order in the market, will be to sell the underlying market, so typically the guy who put the order out is not going to get filled."

But FX clients are not stupid. "It will be no different from how the market works now," says Glodjo at Forexster. "At the moment if you want to trade Eu100 million you are not going to phone up one bank and say that you want to trade Eu100 million, because they will squeeze you dry." Although some corporates may be more concerned with their relationships with banks than a pip or two on a trade, a large proportion of FX flow is speculative, generated by savvy hedgefunds, and it is a matter for debate how much they value their relationships with banks.

Powers of persuasion
But the real problem for Forexster is that it will not work without the banks, and those banks are not going to sign up to something that jeopardizes their revenue. "It seems to me that that is the fatal flaw with this plan: banks guard their client base above everything else," says one market participant. "The possibility that they would give up that client base to a third party who then seeks to disintermediate them, seems remote. I wouldn't like to be the salesman that has to pitch that to the banks."

The key to getting these banks on board will be to convince them of what they already admit in private: that client-to-client trading is inevitable. Says the banker who is in talks with Forexster: "Why would any bank that has a business model that is successful change that model to something that could threaten its existing revenue stream? The answer to that might be: because if you don't then someone else will. I don't think that it is necessarily an easy sell but the real push could come from the client side. And those members of the buy-side that are frequent users of the market seem to be very enthusiastic about it."
Forexster is lobbying large hedge funds and other participants in the foreign exchange market in order to drum up support and apply pressure on the banks. "In the short term, the banks will lose some money, that is true," says Harvey at Forexster. "But I think that banks that are visionary will realize that they still make money. Sure it will be less, but if they are the first in they will gain a strategic advantage."

According to Glodjo, an announcement of a bank signing is imminent. Forexster is in the final stages of talks with at least one major investment bank and is in discussion with others. "We have five other banks which have expressed keen interest to participate and will commit to connect to others," says Glodjo. "We do not have signed agreements but I believe that is only a question of working out the terms." That could be a lengthy process.