Modelling online trading

The online FX market is becoming more sophisticated all the time. There are different models coalescing in for each different constituent group within the industry. But with a number of platforms servicing each market group, and with trading portals in other markets targeting the FX space, the competition is getting fiercer all the time. Denise Bedell explores the various models used for liquidity provision in online FX trading and how the market is changing to meet the needs of different traders.

Denise Bedell

In addition, some market participants question the true liquidity available through certain models, and what exactly the risks are should the market undergo a serious stress. For investment managers and corporates trading relationships are critical, thus single-bank portals and non-anonymous multi-liquidity-provider platforms continue to be the models of choice. However, for those traders where the FX business is more commoditised, price is key and relationships are not as important – such as hedge funds – then anonymous platforms with executable streaming prices may be better suited to their needs.

How such platforms provide liquidity depends on the market they are targeting, be it request-for-quote – the traditional method first used when online trading first hit the market; executable streaming price – be it anonymous or non-anonymous; ECN models where liquidity is brought together from a number of different sources; and so on.

Explains Richard Estes, vice-president, global head of marketing e-commerce at Bank of New York: "Originally when clients were looking to trade, they would click on a button to request a price. In the time between the price quote and executing the trade, the price could have changed. This was an issue for the buy-side because they want to be able to click on a button and complete the trade without the possibility of a change in the price."

Hence, executable streaming prices (ESP) were introduced on a number of platforms – creating an FX marketplace model where prices are updated constantly and

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are available immediately. "The theory in creating a platform designed as a marketplace is that any participant could trade with any other," says Estes.

"However, this would disintermediate the banks, which is problematic since non-bank participants are not in the habit of making markets and providing liquidity," says Estes. "The only way that these exchanges succeed is by asking banks to supply liquidity."

With ESP came the advent of anonymous platforms, where the liquidity provider is not shown. Says Chip Lowry, managing director of State Street Global Link/FXConnect: "With anonymous models, there is no relationship between price maker and price taker. It's unclear whether institutional managers are interested in sacrificing relationships with their liquidity providers. Hedge funds, on the other hand, sometimes care only about price so the anonymous model works for them."

The ESP model, whether anonymous or non-anonymous, has faced some serious controversy. The big issue is over the true value of liquidity available on the various platforms offering executable streaming prices.

Says Lowry: "The problem is that you can have big banks showing liquidity of $20-$30 million on several different platforms, but that doesn't mean that there is $90-$120 million of liquidity available. If there is a big stress on these platforms, it could present a real issue."

"We have not had a real stress to test this," he adds. "The two most stressful times recently have been September 11 and July 7. Back in 2001 online trading was just getting off the ground, so it wasn't as big a deal. On July 7th, which was a tragic event by any standards but not on the magnitude of September 11, banks did pull their pricing engines offline."

"They had never been tested like that before, and the result was that they ended up turning it back on and rerouting liquidity through a different branch. But if people had been offline for a long time that would have been an issue," says Lowry. The question is still out there as to what would happen in such a situation, however most providers have been working hard on redundancy of systems. As such security increases, the risk decreases.

Estes believes that the model of executable streaming prices will remain and coexist with other conventional formats that have arisen in e-commerce. "But there will be some consolidation – some banks will question whether they want to be committed to providing liquidity in this way," he says.

Says Tom Roche, global head of Financial Markets eCommerce at RBS: "The anonymous ESP model, in particular, has encouraged a deep conversation about that type of business. For relationship-driven banks like ourselves, while we support such platforms, we do continue to evaluate the model. For those banks where relationship is less of an

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Global Head of Financial Markets eCommerce, Royal Bank of Scotland

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issue then these platforms can be attractive from a liquidity acquisition perspective."

"However, we will see that banks' ability to stream prices to many different platforms is a question," he adds. "I think many banks will become more selective in terms of which platforms they provide liquidity to. That, together with the cost of technology, will challenge the viability of certain platforms."

But, Michael Weiner, co-founder and managing partner of COESfx, believes the liquidity concern is overblown: "If we have seven banks on our system, we don't have a trading desk so our liquidity comes from those seven banks. The contract we have with the banks is that whatever they are displaying they are good for. For example, if we have $50 million on euro-dollar, refreshed every 3/10 to 7/10 of a second. "If one of these major banks couldn't handle the demand that we are putting through then that bank shouldn't be in the forex business," he concludes.

Some platforms offer more than one model for liquidity delivery, for example RFP and ESP, thus targeting a larger client-base, and competing for more market share. David Ogg, head of LavaFX at LavaTrading, says that the market has room for the various different trading models, but that platforms face increasing competition. "There will probably be some consolidation – but it is a very large marketplace and there are very different needs from different client bases."

He adds: "Our particular model appeals to clients such as asset managers and hedge funds, who look at our platform as way of maximising their performance." LavaFX aggregates multiple sources of FX liquidity into a single access point – the ECN approach – which can be drawn on via the LavaFX user interface, or through a FIX API.

Says Roche at RBS: "There is space for a number of platforms in each market segment, but competition will intensify, so it will be quite challenging for some of them to survive long-term." What the future holds is unclear, but what is clear is that the online FX market continues to grow at a phenomenal rate, and users are looking for greater sophistication from their providers. ■

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Denise is a freelance finance journalist covering the treasury and cash management fields for the past seven years. She also writes in the areas of corporate finance, structured finance, asset and project finance and the insurance markets, and authored her first book - Successful Exit Strategies for the Insurance Industry - in 2003.