Online foreign exchange trading in Germany – a market poised for growth

In Germany, the scene is set for a major shift in the trading of foreign exchange – moving away from the telephone and embracing systems that offer complete automation of the trading process. Market participants have traditionally taken a cautious approach to online foreign exchange trading, but attitudes are changing. Already, according to estimates by the HVB Group, up to 10% of daily turnover in the German foreign exchange is conducted online.[1] A raft of anticipated changes – from the change in status of the state banks, or Landesbanks, to the emergence of the hedge fund sector – now combine to make conditions ideal for a surge in online foreign exchange volumes.

Global rise of e-forex

The anticipated rise in German online foreign exchange trading is in part a reflection of an international trend. The global rise of e-forex has been well documented. Since the advent of multibank foreign exchange portals four years ago, the proportion of FX trades executed online by corporations and financial institutions has soared – in the last year, online foreign exchange volumes doubled to $8 trillion[2]. At FXall alone, we have recorded 300 percent growth year on year, and our market share in the multibank market is close to 50 percent.[3]

The Mittelstand and relationship banking – a changing landscape

Despite the compelling benefits of executing foreign trades online, take-up of e-forex by German companies was initially slower than anticipated.

A possible explanation for this is the general economic significance of regional business, and the SME sector (known as the Mittelstand). Specifically, regional business is estimated to account for at least 50% of foreign exchange volumes in Germany[4].

Mittelstand companies have typically placed a high value on personal banking relationships, preferring to deal foreign exchange with a local bank branch rather than a remote contact in Frankfurt. The close ties that exist between banks and corporations in Germany (strengthened by cross-holdings and the state guarantees that enable the Landesbanks to offer low cost loans) make it still more likely that regional businesses will concentrate their FX business with a single provider - often one that has offered it credit lines on favourable terms.

However, changes in the German economic and regulatory climate mean that these close ties are beginning to loosen. German banks have begun to look more closely at ways to increase the profitability of their businesses, both by shedding non-core assets such as stakeholdings in corporations and by rethinking traditional business models. The Landesbanks are under particular pressure. In July 2005, they will lose their state debt guarantees and, in consequence, will be forced to focus on eliminating unprofitable activities, such as subsidized lending. This may erode the cornerstone of their relationships with regional business. In this environment, third party FX dealing has begun to blossom, and multibank foreign exchange portals, which offer corporate clients a greater depth of liquidity and more competitive pricing, are growing in popularity.

German multinationals welcome compliance and value-added online FX services

Germany's larger multinational corporations already maintain numerous banking relationships and are well versed in online foreign exchange. For these corporate clients, local banking relationships are rarely a determining factor in the allocation of foreign exchange – instead, providers are selected on criteria including pricing, straight-through processing and depth of liquidity. For plain vanilla trades at least, online trading is increasingly becoming regarded as the default transaction method – it is fast, efficient, and dramatically reduces the risk of errors and misunderstandings.

[1] *FX Client*, 'Germany looks to the corporate sector', Summer 2003
[2] Greenwich Associates Report, March 30 2004

FXall is already established globally as the leading multibank foreign exchange portal. The speed, operational efficiency and cost savings delivered by online trading have undoubtedly played a crucial role in establishing online execution as an attractive alternative to telephone dealing. Customers also welcome the broad array of value-added features offered by FXall – such as Settlement Center, which extends straight-through processing throughout the entire trade lifecycle from dealing through to settlement preparation.

The need to establish best practice is another important driver. By executing deals over FXall, participants can be confident of meeting local and international best practice guidelines for forex trading. The ACI Model Code's recommendations for foreign exchange trading include maintaining full audit trails and the prompt delivery of trade confirmations, settlement and payment instructions.

Relaxing regulation paves the way for hedge funds and prime brokerage

The beginning of this year marked a turning point in the liberalization of German financial markets, and a much welcomed opening for the alternative investment industry, when the legislative authorities ushered in a bill allowing the sale of hedge funds to retail and institutional investors. The prospects for future growth look strong. Estimates suggest that if German investors follow the international pattern and invest just two per cent of their assets in hedge funds, the market in Germany will be worth around $120 billion in the next five years.

Hedge funds are a key market for online foreign exchange services, and currently represent FXall's fastest-growing customer segment. Crucially, hedge funds recognise that successful foreign exchange trading is about more than just execution. It goes without saying that they want fast, tight pricing with minimal slippage from all their chosen liquidity providers, but that's not all they require. Hedge funds also want solutions for all of their workflow requirements, including post-trade processes, as well automated connectivity to all of their counterparties.

[3] Euromoney foreign exchange poll, May 2004
[4] *FX Client*, 'Germany looks to the corporate sector', Summer 2003

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As the sector evolves, Germany's hedge funds are also likely to drive demand for prime brokerage services. Prime brokers are, for hedge funds, an indispensable part of the FX trading process, separating the need for deep liquidity on the one hand, and the hedge fund's access to credit lines on the other. They give funds access to a large number of banking relationships, enabling them to obtain the most competitive prices available. By outsourcing transaction processing, FX prime brokerage also enables hedge funds to concentrate on investment strategies rather than back office administration. Using an electronic solution to streamline messaging reduces processing costs for prime brokers - cost savings that they can then pass on to their clients. It also saves time and keeps operational risk to a minimum.

To sum up, the general benefits of online foreign exchange trading are becoming increasingly apparent to German corporations and institutional clients. The growth of the German FX prime brokerage industry has been hampered, to date, by regulations that require the majority of investment funds to concentrate FX trading with their custodian bank. However, these rules are expected to be relaxed over the coming year. Advancements in electronic messaging - removing the settlement risks associated with dealing away from the custodian - are paving the way for a dramatic increase in third party FX dealing and hence the take-up of FX prime brokerage services. All this makes Germany ripe for a real transformation - and one of the most interesting markets to watch this year.

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