



Where's the demand for FX White Labelling coming from?



FOCUS ON WHITE LABELLING

Every new innovation requires two separate forces to create a market place success - on the one hand a willing supplier who will invest the technology, capital and managerial talent to turn the innovative concept into a tangible product or quality service - and on the other hand a group of potential customers, who will invest their time, reputation and talents in trialling, and if successful, becoming the early adopters of this new innovation.

In other words, it takes two to tango - no amount of willing suppliers can do it by themselves. Much of the publicity about the potential white label revolution in delivering foreign exchange services has been generated by the supply side - the large banks who have built sophisticated integrated trading and risk management capabilities and who wish to improve the return on this investment by increasing the volumes passing over the system. Their economic argument of the benefit to the potential customer, a downstream bank or broker, is that they have built a high fixed cost operation with lower marginal costs than the downstream bank can achieve. By providing this service to replace all or part of the downstream institutions capability on a white label basis, the difference in lower marginal costs can be shared between the parties, and the downstream bank can also save some of its overhead costs of being in the business.

This article will attempt to answer the question of where the demand, not the supply of foreign exchange white labelling is coming from. A larger institution may offer a total outsourced foreign exchange dealing service to a smaller institution and conventional economics tells us that a drop in costs of supplies will increase demand. But are small and medium sized institutions rushing to take this offer and reduce their costs? Or is the actual uptake still only a small fraction of the potential demand, because the allure of lower input costs is only a small part of the total formula that drives the successful business model of the downstream player. In other words, the potential of lower costs will create interest, but this interest will only turn into actual demand if it enhances the overall business model of the client.

Michael Porter in his book 'Competitive Analysis' describes three viable, but incompatible, long term strategies:

- Lower cost provider
- Differentiation of total service
- Unique niche focus

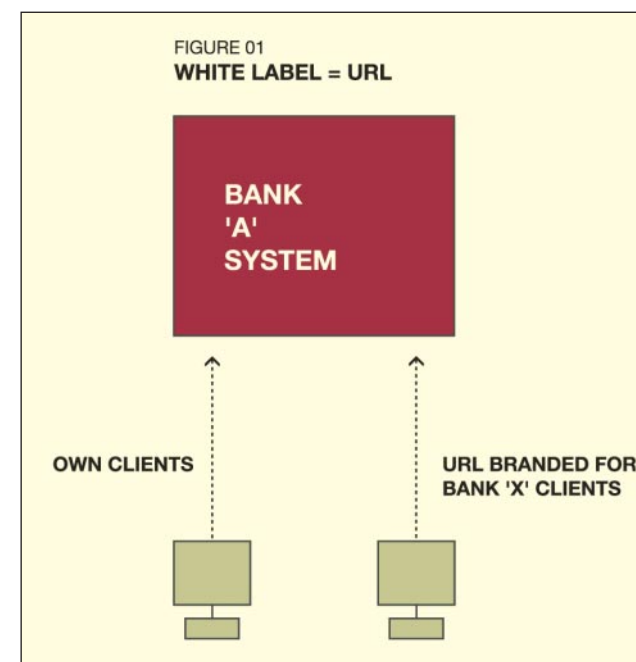
There is a market for the lowest cost provider in foreign exchange, and at the end-customer level, this is dominated by the foreign exchange brokers who allow speculative investors to trade at inter-bank market prices in lot sizes as small as \$100k. This market not surprisingly has been the dominant market to date for white labelled liquidity.

The business model of most of the top 200 banks however has never been on the lowest-cost provider concept. The small number of global trading power-houses could always produce another ticket at a lower marginal cost, but the banks which dominate the local corporate and investment management markets in most countries around the world provide a total package of services which are differentiated according to the needs of their clients. In the age of electronic foreign exchange, this differentiation is achieved by the control and customised development of key aspects of their own platforms - not by outsourcing their business in totality.

Beyond the top 200 banks the picture again changes as the business strategy of a smaller institution will tend to be a unique niche focus. The importance of foreign exchange services may be small and incidental, or relatively large and important depending on the unique circumstances. In some cases complete outsourcing to a white label solution may make sense, in others 'in-sourcing' some electronic liquidity to their own system may be better, while in others, electronic foreign exchange may simply not be relevant.

White Label Distribution Models

We shall now examine these customer trends in the context of the different white label distribution models which involve either complete or partial outsourcing of either liquidity, or liquidity and technology platforms combined. There are a variety of approaches which fall under the umbrella term 'white labelling' and these have different strengths and weaknesses depending on the type of institution involved. Cognotec has found that many institutions are not clear about the differences between the various white labelling models.

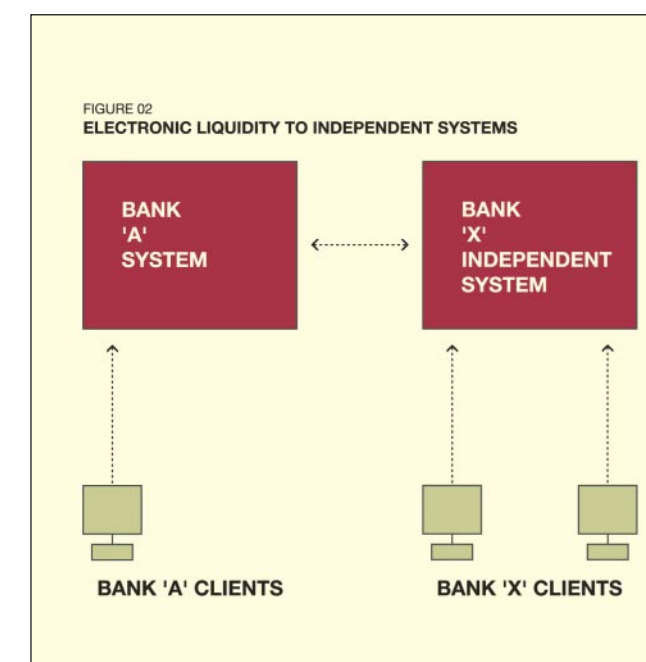


White Label model 1

The first, and currently dominant model (fig 1), is one which involves the market making bank completely hosting a foreign exchange trading service for another bank. In this scenario the hosting bank effectively takes over the hosted bank's business. The hosting bank controls all data and provides a branded 'wrapper' for the downstream bank's front end screen so that the system appears seamless to end-users.

This is the easiest form of white labelling for the hosting bank to implement and the marketplace has experienced quite a lot of initial business in this area. However, it must be said that there could be myriad problems for the downstream bank going forward. First and foremost, after implementing such a system, the hosted bank could find it almost impossible to re-enter the market as an independent player. Over time, the white labelling bank may become the dominant partner and there may be concerns regarding control of client details, margins and credit utilisation. In addition, the hosted bank cannot 'shop around' for the best prices and is in effect tied to the host bank's desk. In summary this could be an ideal solution for a bank who wants to exit the foreign exchange business while continuing to provide a branded service to its clients.

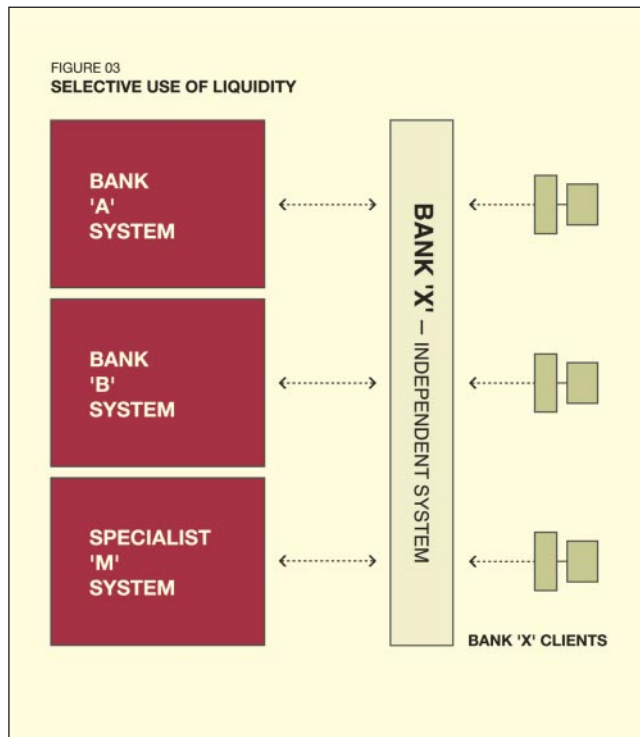
What we have observed of this kind of white labelling is that this level of dependency is unacceptable to those banks who want to keep and develop their customer franchises. As a result two more white labelling models have emerged which offer greater flexibility 'in-sourcing' liquidity without the high level of dependency on the host bank described above. As a result, these also limit exposure to sole dependence on the hosting bank. The key here is to unbundle the total package of technology solution and outsourced liquidity so that each component can be offered separately, to establish a best of breed solution for the bank.



White Label model 2

The key to the second model (fig 2) is that the downstream bank (X) retains control of its own infrastructure and sources prices remotely from another, upstream bank. The technical infrastructure can be maintained by a third party remotely, absolving the need for the downstream bank to have technical responsibility for the system or it can install a technology solution in the bank complete with the necessary communication protocols to obtain on line liquidity from other banks. The hosting bank provides a continuous stream of prices but receives no information on the end client, and the size of tickets or margins applied. The downstream bank can take some or all liquidity from an 'upstream' partner bank, but can also make prices and take positions in certain currencies if it wishes on its own system.

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White Label model 3

The third scenario (fig 3) is a more sophisticated version of the previous model where the hosted bank can choose liquidity offerings from a number of supplying banks, thus ensuring the most flexible overall solution. This could be by best of breed in regional currencies, or by time of day, for instance.

The bank can then margin this up for individual clients as it sees fit. It can also choose to take liquidity in order to complement its existing service offering, e.g. to offer additional currencies and/or time zones. In addition, the downstream bank can supply currency services back to the supplier banks in for instance its own regional currencies, where it may have considerable expertise. This scenario supports a two-way relationship between 'up' and 'downstream' bank and leads to less dependency for the latter.

Cognotec's Liquidity Linq™ service combines the Cognotec trading platform with liquidity supplying/liquidity buying banks in flexible structures such as those described in scenarios two and three. We believe that, going forward, the marketplace will seek more white labelling offerings supporting these models, as scenario one becomes too limiting to potential white label buyers.

As in many areas of business a bundled offering may be ideal to a relatively small user, while a larger user may wish to unbundle an offering to optimise the value to him of each of the different components. We can see that since the first white label licenses in 1997 the world of foreign exchange trading has moved on considerably. In the electronic age it is not enough merely to participate, the process of improving processes and maximising the efficiencies available by utilising new technologies has already begun in earnest. Pressure on profitability and service levels can be met by selective exploitation of the benefits of white labelling models.

Conclusion

While the early promise of white label may not have been fulfilled, demand is growing for a more sophisticated range of solutions, which unbundle the all or nothing approach, in favour of working with the unique and customised requirements of each client.



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