Forex Margin Trading at Crossroads

Shakeout Looming on Tougher Curbs

By Katsuhiko SAKAI

Trading in foreign exchange on margin allows investors to trade several times to several hundred times more money than the margin they are initially required to deposit. They can expect to gain far more money than the margin deposit, although they may incur heavy losses sometimes. Forex margin trading via the Internet has grown popular as an easy investment instrument among retail investors in Japan. After taking advantage of booming Internet-based forex margin trading for its fast expansion, the Japanese forex brokerage industry is now reaching a turning point. Amid an intensifying race to lower brokerage commissions and attract customers, brokerages failing to withstand profit declines have dropped out one after another. The business environment for the industry has grown even severer as regulations on forex margin trading have been toughened this year to protect investors. In the future, industry analysts say, the number of forex brokerages handling margin transactions could decline to one-third of the present level.

Investor Protection Makes Great Progress

The Financial Services Agency took its first measures to toughen forex margin trading regulations on February 1. These measures require brokers to put all customer deposits into trust accounts and tighten rules for loss-cutting transactions to limit customer losses. The measures came after the Securities and Exchange Surveillance Commission found financial and risk management problems at 60% of forex brokerages. Some used customer assets illegally while insufficient loss-cut trading systems led investors to incur greater-than-expected losses.

Customer assets subject to preservation in trust accounts were expanded to cover unrealized gains and swap points, or interest rate gaps between currencies, as well as the margin deposit principal itself. For "cover deals" that brokers conduct with large banks called "counterparties" to avoid risks accompanying customer orders, the new measures prohibit brokerages from using part of customer assets as collateral and require them to raise all the collateral on their own. In deals involving non-major currencies such as the less liquid South African rand, counterparties have growingly asked brokerages to increase their collateral.

On August 1, a second set of measures to toughen forex regulations took effect. One of them limits the leverage to 50 times the amount of margin committed by customers. In one year, or in August 2011, the leverage cap will be lowered to 25 times.

Forex margin trading is attractive in that investors can trade far more money than they are required to commit as margin. But some brokers offered leverages as high as 600 or 700 times, leading over-leveraged transactions to become problematic. This was because even a small change in forex rates could lead an investor to gain or lose tremendously.

Investor protection has made great progress on the series of measures to toughen regulations. "Forex margin transactions have come closer to low-risk financial instruments," a forex brokerage industry source says. "Wealthy people who have invested money in foreign currency deposits and bonds may enter the forex margin trading market due to a greater sense of safety." Industry players expect the tougher restrictions may widen the range of market participants. "Japan could provide a global model case," says an official at a foreign forex brokerage operating in Japan.

Leverage Curbs Cut OTC Forex Margin Trading

Forex margin transactions comprise two types – over-the-counter (OTC) trading, where investors trade with forex brokerages, and exchange-based trading such as "Click 365" on the Tokyo Financial Exchange and "OSE-FX" on the Osaka Securities Exchange.

The Financial Futures Association of Japan says OTC forex margin transactions in fiscal 2009 increased 18.3% from the previous year to 2,093 trillion yen, accounting for 96% of the 2,180 trillion yen in total forex margin trading on a notional value basis. The total represented a 19.6% leap. Exchange-based trading fell short of 100 trillion yen in the fiscal year (to March 2010), but scored a far faster increase of 64.0%.

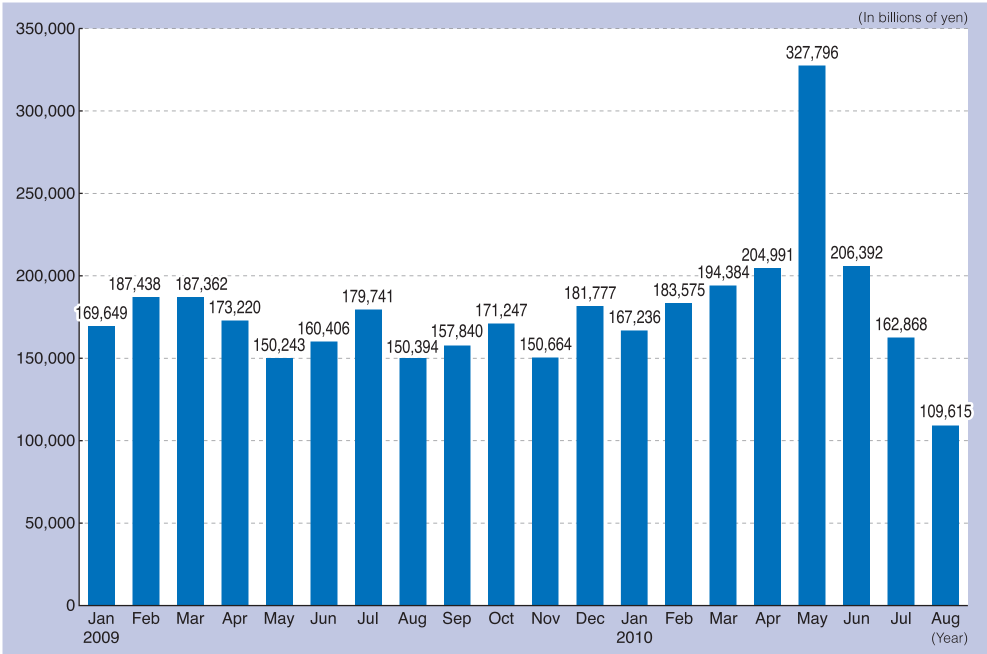
The association's monthly bulletins showed that OTC trading continued to expand for four months from February as foreign exchange rates fluctuated wildly on the European fiscal problem. In May alone, OTC deals increased 59.9% from the previous month to 327 trillion yen. But they declined in June and July as some forex brokerages discouraged investors by lowering leverages preemptively before the introduction of the leverage cap in August. Indeed, OTC trading plunged 32.6% to less than 110 trillion yen in August from July as the leverage limit was imposed.

Meanwhile, exchange-based trading continues to rise steadily in general. Factors behind the increase may include favorable tax treatment as well as the exchange's leverage as low as five times on average, far below the regulatory cap. Gains on OTC trading are classified as miscellaneous income that is added to other earnings for taxation on the combined income (subject to a tax of up to 50%), while those on exchange-based trading can be separated from income for tax returns and subjected to a uniform 20% withholding tax. Gains on exchange-based trading can also be consolidated with gains or losses on commodity and other exchange-based

futures transactions. Losses on such trading may be deducted from taxable income over a period of up to three years.

Investors may continue to shy away from OTC forex margin trading. Particularly, emerging forex brokerages are likely to lose massive numbers of customers after taking advantage of leverages above 100 times to achieve quick expansion of trading. In a study report published in August, the Yano Research Institute forecast OTC forex margin transactions would decline to 1,750 trillion yen in fiscal 2010 and to 1,320 trillion yen in fiscal 2011 when the leverage cap will be lowered further. The forecast fiscal 2011 level is less than 70% of the fiscal 2009 level.

Trends of OTC forex margin trading



Source: Over-the-Counter FX Monthly Report by Financial Futures Association of Japan

Exchange-based Trading Race Getting Fiercer

Many brokerages specializing in OTC trading saw their financial burdens increasing on the mandatory placement of customer assets into trust accounts and their income falling fast on a decline in transactions. Among small brokerages that have no room to make massive computer system investment for participation in exchange-based trading, some have offered to be absorbed by larger ones.

But the leverage cap introduction has prompted large OTC trade-oriented brokerages to participate in exchange-based forex margin trading that has remained minor against more popular OTC transactions. Remarkable among them are securities companies that have developed their brand power through stock trading.

Daiwa Securities Co. and Okasan Online Securities Co. have raced to offer the lowest brokerage commission for Click 365 transactions since February, expanding their respective market shares in these transactions. Nomura Securities Co., which had handled OTC forex margin trading only, launched Click 365 brokerage services in August. Mizuho Securities Co. is expected to follow suit next spring. Major securities companies are thus likely to intensify competition in expanding their shares in exchanged-based transactions.

Commodity futures brokerages and other relatively smaller firms, which have accounted for most of the older brokerages involved in exchanged-based trading, are in great fear of larger firms' participation. Large companies have survived fierce competition in OTC forex margin transactions and are believed certain to offer commission cuts. "Brokerages engaging in exchange-based trading must have sufficient business resources to survive fierce competition in the future," a brokerage official says. "The business may not pay for small brokerages."

Industry Shakeup to Intensify Next Summer

The number of forex margin traders has declined to fewer than 100 from slightly fewer than 130 at the end of December 2008. Over the past two years, these brokerages, including those for exchange-based trading, got out of business, sold business resources or integrated with each other. But these developments amount to only the beginning of the industry's reorganization. A full-fledged shakeup is expected to come in or after August 2011 when the leverage cap will be lowered to 25 times. Recovery in forex margin transactions is expected to take much time. "Only some 30 brokerages may survive eventually," Ueda Harlow Ltd. President Naoyuki Kimura says.

The forex margin transaction market, which had featured speculative over-leveraged trading, is now being transformed into a stable market for sound investment. Forex brokerages' survival may depend on whether they can offer added value in place of high leverages. Downward pressures on brokerage commissions will continue to increase as competition intensifies. The time has come for customer investors to comprehensively consider brokerage service security and quality as well as service costs.

Brokerages are testing new approaches. FX PRIME Corp., a major brokerage for OTC forex margin transactions, sponsored a countdown event named "Employment Data Night" at a Tokyo café on the night of August 6. In a bid to allow individual investors to grow more familiar with forex margin trading in the event timed to coincide with the release of US employment data as a major factor for foreign exchange markets, the brokerage explained market developments just before and after the release and arranged discussions among economists and an exchange party. The brokerage attempted to retain customers by providing an opportunity for face-to-face communication in the Internet-based forex margin trading world. This was its second event. The first was in May. Participants gave high ratings to the event. "My impression of forex trading has changed," one participant said. "The event was good in that we were allowed to listen to comments on a real-time basis," another said. JS

Note: This is the last in a series of articles for the FINANCE column, which concludes with this issue.

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