Making the case for change in Post-Trade FX processing

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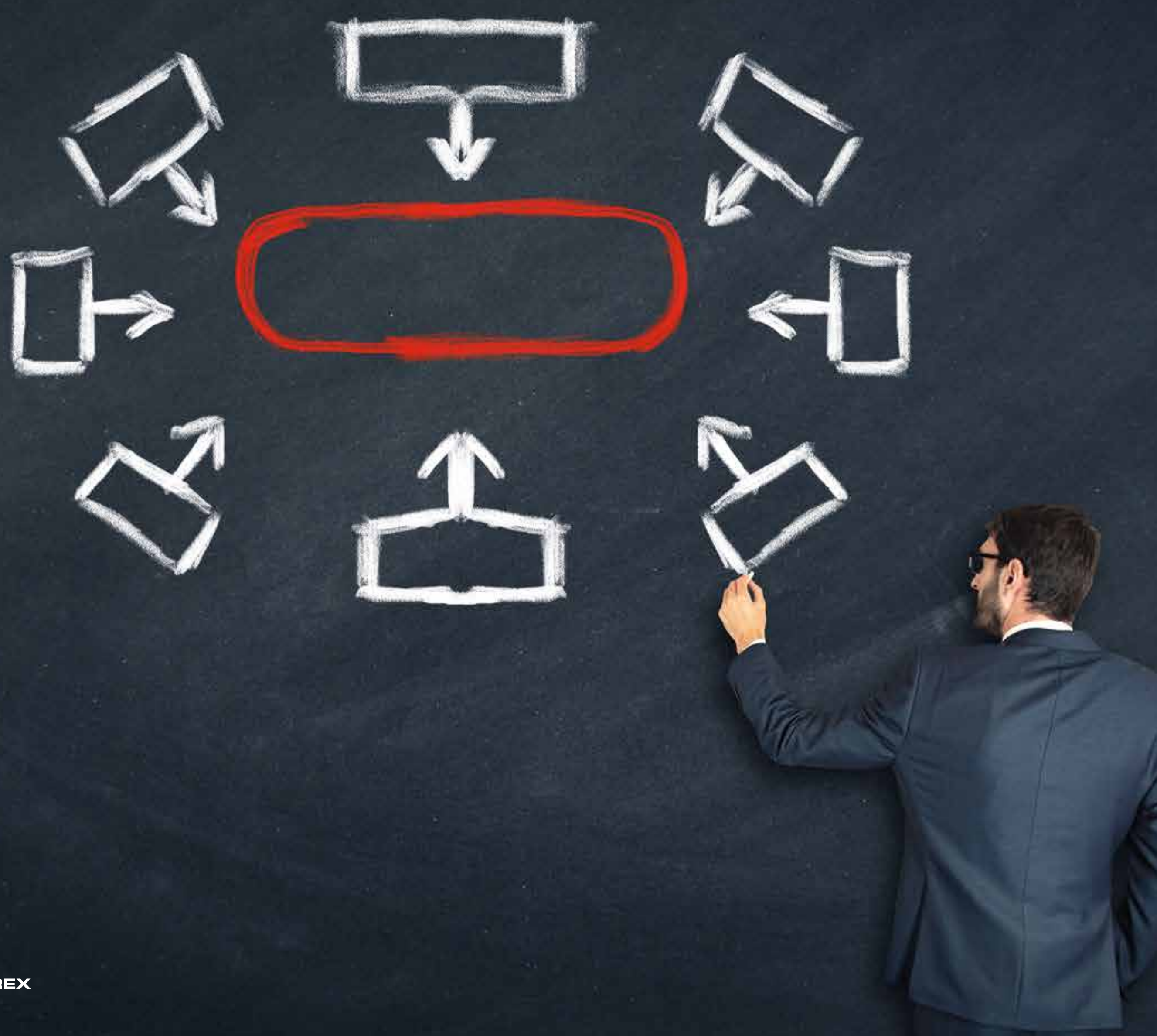
TRADING OPERATIONS



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As return on equity in financial markets continues to remain stubbornly low and often below funding costs, business leaders need to consider their options to address core underlying profitability. Many have already deployed the traditional options of offshoring, nearshoring, outsourcing. And still industry wide ROE is below 10% against a higher cost of capital. This position is not sustainable and so new approaches and different target operating models need to be considered.

This dilemma is forcing a fundamental shift in the search for business solutions that can build on the industry trend for the mutualisation of cost models, where a common facility is shared by many market participants. However this shift needs to be made against a backdrop of a multi-year general lack of investment in middle and back office technology and operational processing.

FX operations took a leap forward in 2002 with the launch of CLS (for multi-currency cash settlements) covering spot, forwards and vanilla swaps to mitigate so-called 'Herstatt Risk'. This covers the majority of the STP market which is a high volume but low margin business. However, the '80:20' rule is applicable here – broadly speaking the non-CLS FX and OTC transactions cover 20% of total transactions but create 80% of the processing touch points for operational units – and hence the majority of operational costs.

SHARED OPERATING MODELS

Unfortunately, when we consider the full transaction processing lifecycle in FX, the adoption of shared mutualised operating models is the exception rather than the rule; with only CLS and SWIFT being examples of such a shared model. So the question arises; are there other parts of the transaction processing lifecycle that could benefit from the adoption of a shared operating model that can deliver economies of scale, the mutualisation of standards, data and process and at the same time incorporate the benefits of technology innovation such as cloud, artificial intelligence and distributed ledger technology.

When we consider the business mix of most FX businesses, we observe higher daily transaction volumes, lower margins and yet higher expectations from customers in terms of lower costs and better service. These expectations, coupled with increased regulation for best execution and reporting, create an unsustainable operational challenge for most FX market participants.

To maximise the benefits of mutualisation and to investigate the potential networked value of being on a shared operations and technology platform, forward-thinking institutions are looking for service providers to deliver a new target operating model.

To date FX firms have simply 'lifted and shifted' a broken, inefficient operating model and legacy technology to low cost near shore and offshore locations. This has created some savings, but not really moved the needle. And moreover, the opportunities are limited to move any further towards a better operating model.

CHANGE EFFORTS

Change budgets are increasingly focused on meeting mandatory regulatory and market change requirements; however, this is mainly being achieved through the addition of processes, controls and reporting on top of already offshored inefficient processes that sit on legacy infrastructure. Firms lack the mandate to fundamentally implement an agile business process reengineering project to the current business with a view to achieving transformational change: instead change effort is limited to small-scale efficiency and run-the bank (RTB) fixes to meet the deadlines set. Most FX operations leaders dread the recurring annual paradox of being asked to further reduce costs whilst not introducing any additional operational risks.

The industry needs a paradigm shift; a new way to think about the problem.

The vast majority of tickets are processed through CLS. However, this does not equate to the majority of gross-traded value. Currencies supported by CLS enjoy safe settlement on a PvP basis, netting prior to settlement and a swap facility between members allowing for a >70% reduction in funding requirements.

Then there is the non-CLS-enabled market representing the remaining balance of tickets not enjoying any of the above, aside from on a bi-lateral

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basis with each counterparty. It is this sector which for some, represents the vast majority of the operational and risk cost. This sector of the market has multiple points of failure, with each of those points representing operational risk and cost.

There is much to be gained from standardising for mutual benefit and this has been borne out through the introduction of SWIFT messaging standards. Mutualisation delivers scale and common efficient processing which reduces cost, as we are beginning to see in the mutualised service that Broadridge provides for the equities and fixed income areas within capital markets. In line with this, the general consensus is that there is no strategic differentiation or competitive advantage from owning the key functions of back office processing. This is where the power of a mutualised service provider adds the additional cost benefit 'kicker' when both mutualisation and outsourcing are combined onto a single proposition.

Operations cannot offshore any additional functions; in fact many firms are recognising that offshoring without business transformation has not delivered the benefits anticipated, and are bringing functions back to near shore locations.

SINGLE SHARED PROCESSING PLATFORM

Imagine if there was an opportunity for the FX sector to operate on a single shared processing platform enabling participants to concentrate on business strategy and client service as opposed to run the bank (RTB) activity. Imagine stripping away the typical causes of breaks and unmatched trades preventing settlement of billions of dollars of currency every day.

Imagine not having to call the client to explain why they did not receive their funds and having to make good the value. All of these problems currently occur every day and are eating away at the small margins in FX trades.

The benefit of a standardised shared processing model will be a more efficient post-trade process via a centralised but appropriately segregated operation utility with efficient matching and exception detection and resolution.

It must also be remembered that a mutualised, multi-client service would also have the capacity to bring network benefits that can benefit all participants. There could, for example, be an opportunity to drive

Offshoring

This is where existing processes are simply 'lifted and dropped' onto legacy platforms in more cost-effective locations

Business Process Outsourcing (BPO)

This is the contracting of non-primary business activities and functions to a third party provider

Managed Service Provider (MSP)

An effective MSP is a world class services provider with subject matter expertise in financial services, typically leveraging their own market leading technology to drive scale and innovation

Figure 1: Varients on the outsourcing model

efficiency through a more holistic industry view of recurring operational pain points, and the ability to leverage common facilities such as a central point of transaction matching. As a result of this, the RTB costs would be reduced, leading to increased margins. This shared operating model, with its fundamentally greater efficiency, could also better allocate Change The Bank (CTB) spend to investments on technology innovation that can drive even further cost benefits. Artificial intelligence can automate most remaining manual processes. Blockchain can create common shared pools of data. Cloud-based applications can deliver lower cost platforms that are more agile and responsive. Digital tools can put the power of data in the hands of the FX user. Together these ABCDs of InnovationTM will each deliver a better operating environment in FX. All require investment – investment that can best be achieved by pooling resources and sharing R&D effort.

TECHNOLOGY DISRUPTION

The challenge is clearly that we are soon to enter a period of fundamental technology disruption which will impact currency flows and challenge traditional FX processes and participants. By working on a shared standardised operating model the FX industry would be better positioned to start to drive consensus and establish the thought leadership and technical expertise to actually speed up adoption of technology innovation while lowering the level of disruption.

So the benefits of a shared managed service operating model are clear; lower cost and risk, better adoption of standards, greater ability to embrace technology innovation. However while the attractions of mutualisation are evident, the challenges require robust debate. Decision makers within banks are focussed on regulatory reforms and incremental business transformation to meet business and market needs; there is little appetite or management bandwidth for considering new transformational operating models.

Such models might be perceived as risky or too big to contemplate. However, status quo does not appear to be a viable option for the medium term. It therefore falls to potential providers of such shared operating models to demonstrate the business case, set out the quality of their governance model and the robustness of their SLAs. Providers need to prove out the viability of their technology and operating model to support multi-client shared delivery that aligns to the business goals of each participant firm.

Figure 2: FX challenges

FX Challenges	Interbank	Other FIs and Wholesale banks	Corporates/non-FI customers	Why is this a challenge?
The 'New Normal' of regulatory change	✓	✓		• Change budgets are focused on regulatory requirements which are usually built on top of existing, inefficient processes • Resource and budget constraints prevent business reengineering projects improving operational efficiencies
Establish best practices for the FX market: enabling market participants to transact at prices that are reflective of market conditions and based on an agreed 'code of conduct'	✓	✓	✓	• Requires working groups such as Foreign Exchange Committee (FXC) and Foreign Exchange Benchmarking Group (FXBG) to work with financial institutions globally to establish best practices in a market that is being closely monitored by regulators
Management of FX risk: Lack of visibility/ transparency of FX exposures and reliability of forecasts			✓	• Largely due to lack of automation and subsequently a high degree of manual processing. Makes it difficult to accurately hedge and forecast in a timely manner and to communicate changes • Makes the use of natural risk management techniques, such as cash flow netting and exposure matching, more difficult
Erosion of margin due to competition, increased use of electronic trading platforms, regulatory implementation/ reporting overheads, capital adequacy provisions	✓	✓		• Innovative solutions are increasingly required, however, there is limited budget to focus on these whilst at the same time supporting existing platforms
Global Systemically Important Banks (G-SIB) and Tier 2 institutions need to not lose sight of strategic direction whilst at same time focusing on regulatory implementation	✓	✓		• Regulatory timelines may not align with timeframes required for strategic solutions, therefore inefficient. tactical solutions are often implemented • Significant budget and resource is assigned to regulatory implementations leaving less resource available for strategic work
Traditional cost-cutting approaches (e.g. moving operations to offshore/nearshore, applying lean methodologies) are exhausted. Further action compromises risk and QA	✓	✓		• Offshoring in isolation is no longer a viable strategy to reduce costs; other transformational solutions are needed
Too fragmented (excluding G-SIB and Tier 2) for economies of scale from offshoring or outsourcing			✓	• Traditional cost-cutting approaches used by larger banks and FIs are not practical; other other solutions are needed

Figure 2: FX challenges - We will soon enter a period of fundamental technology disruption which will impact currency flows and challenge traditional FX processes and participants

CONCLUSION

Our belief at Broadridge is that these challenges are resolvable, and with enough critical mass there are real opportunities for a wholesale change in the way FX trades are processed, building upon and taking to the next stage what has already been achieved by the industry.

In the same way that the advent of CLS was a transformational pillar in the evolution of the FX market, paving the way for increases in volume, participants and risk mitigation, a centralised and mutualised operations model, covering CLS and non-CLS transactions, could empower transformation aimed at the inefficiencies and costly legacy FX operational model. The efficiency and cost changes that institutions have already made just to keep up have played out, and the diminishing returns achieved by tactical change has resulted in organisations being backed into a corner with mutualisation the only realistic next step.