Collaboration, Cost and Complexity

Work continues on modernising Post Trade FX

The FX market has always dealt with fragmentation and complexity but, as Frances Faulds asks, in order to modernise, does the industry need a wholly new model?

The foreign exchange market has gone from a position of strength, in pioneering trade automation, to lagging behind the other OTC asset classes, in terms of post-trade processing, today. While the credit, interest rate and equity derivatives markets have benefited from the greater use of standards and centralised solutions for more than a decade, the FX market is still grappling with challenges such as trade confirmation, options exercise management, and more recently, centralised clearing and regulatory reporting.

While there is some evidence of centralisation, standardisation and collaboration in the FX market, it is not widespread enough yet to have made an impact and there is still much to be done at an industry level. In 2015, IHS Markit launched the first venue-neutral trade confirmation service for FX options, with Citibank and JPMorgan confirming the first trades and more than 50 asset managed firms signed up to use the service, a significant step in terms of enabling counterparties in the FX market to centrally confirm trades.

Regulatory requirements around central clearing and the impact of the uncleared margin rules for OTC products, which have proved to be a catalyst for clearing, have brought the clearing houses into the FX market and the
take up of clearing by FX firms, on a voluntary basis, ahead of any firm mandate. With the launch of clearing services for NDFs, (CME is folding FX NDFs into its existing futures product set), so standardising them with futures and LCH is dealing with FX and NDFs by folding them into its OTC product set, thus providing standardisation but across a different set of products) new operational and margining efficiencies are being made available.

In September this year, LCH’s ForexClear service processed $1.2 trillion in notional and hit a new monthly record of clearing more than 160,000 trades. Commenting on the new records, Paddy Boyle, global head of ForexClear, LCH, said: “These record volumes demonstrate that the margin, capital, risk and operational efficiencies that clearing brings to the market are proving persuasive to evermore market participants.” Furthermore, with now 30 clearing members of ForexClear, LCH says that it is now seeing a growing interest from the buy-side, and is expanding the ForexClear offering with the launch of clearing for G10 NDFs as well as physically delivered FX options.

AUTOMATING END-TO-END

NEX Optimisation includes a portfolio of cloud-hosted services needed to process a transaction from beginning to end, ranging from pre-execution credit checking to multilateral portfolio compression. Andre Choussy, Head of Trade and Portfolio Management, at NEX Optimisation says: “What we offer covers multiple services across the entire post-trade space. We have trade matching, affirmation and confirmation layers, limit calculation engines, allocations engines, then reporting engines, both internally, back to underlying clients, and externally for regulatory reporting in Europe, portfolio reconciliation services; portfolio compression services, treasury and collateral management services and last but not least we’ve started developing some other settlement and payment services. So, we have a whole host of services, through the entire post trade lifecycle from the moment the trade has been executed all the way down to the moment when that trade, or margin, has been settled.”

With these services in place, Choussy says NEX Optimisation is now spending time on further developing services that reduce costs for its clients, and the two costs that the company has been particularly focusing on are capital related costs, as well as funding related costs. Due to the fact that a lot of the new regulations are driven by notional calculations NEX Optimisation has developed a range of tools aimed at reducing the amount of notional that is actually in the system, whether it is through netting or whether it is through compression, to give tools to both the sell-side and the buy-side so that they can minimise the notional that is booked in the system.

Says Choussy: “This is linked to reducing any funding and settlement related costs that are driven by the amount of the notional – at the gross vs net level of settlement, the number of row items that are being settled, and how those actual settlements are being carried out. That has been our recent focus. How do we develop tools that help banks and buy-side clients manage their capital requirements as well as their funding and settlement costs?”

In certain areas of the industry, a lot of the development work and a lot of the technology that was built, historically, was built in a much more reactive way, to address very short-term problems. “By stepping back and providing clients with an integrated solution for post trade services, NEX Optimisation can offer clients a bundled service that simplifies their operational process.”

Collaboration, Cost and Complexity

Although the launch of CLS in 2002 was transformational for the FX market, reducing settlement risk and creating efficiencies in processing, as the FX market is arguably maturing into a low margin business tackling the fragmentation in the market and modernising the post-trade infrastructure, that to some extent was built to support voice-trading, remains the biggest challenge facing market participants today.

CLS standardised the market for FX settlement and two years ago collaborated with NEX Optimisation, which has been conducting compression in other asset classes since 2003, to launch triReduce CLS FX service, a post-trade compression service for the industry. This has already eliminated almost $3 trillion in gross notional value from the outstanding FX forward and swap portfolios. The service has recently been enhanced to include more FX prime brokers and there are further plans to extend the service to CLS third party members and to buy-side firms.
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FLEXIBILITY
But at the same time, clients want flexibility and to be able to access as many different service offerings through one single connection. For example, NEX Optimisation recently partnered with high-speed payments infrastructure provider, Baton Systems, to act as a distribution vehicle for Baton’s settlement payment services. In essence, this means clients obtain an end to end service, addressing all of their needs and consolidating all of the processes as much as possible, but retaining the flexibility to utilise third parties for specific components. “This means we are offering them a centralised solution, but with interoperability out to different services,” Choussy adds.

Baton has joined NEX Infinity as the first third party to provide its services through the platform and NEX Optimisation and Baton have been working with a multi-national bank client of NEX Optimisation to deliver

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a new post-trade solution for FX spot transactions delivered through the NEX Infinity platform, expected to go live in Q1 2018. Combining NEX Optimisation’s matching and confirmation services and enriching the resulting client data with Baton’s settlement and payments services will enable faster asset movement with, and between, banks.

But while some level of standardisation is being brought to the FX market for the first time by the clearing houses, Choussy says there is still not a lot of additional standardisation at this high infrastructural, or macro, level, and as a result the FX market is still fragmentated in terms of providers, whether it is in numbers of execution venues or technology providers, and there is still a lot of fragmentation across the different segments of participants in the market.

However, Choussy believes that in some ways the fragmentation in the FX market has been beneficial because it encourages more competition and also addresses the diversity of the FX market - that no two hedge funds, no two asset managers, or no two banks are really identical in business operations. “Each of them has a different view of how they want to process trades and how they want to handle operations. So, there are still a lot of idiosyncrasies out there, with existing systems and existing end clients and so there is a need to have different services, for the different client segments - services concentrating of prime of prime services, services specialising in FX options, or trading services. Some of this...
fragmentation is driven by market demand and it does encourage a lot of competition, so some of it is good.”

According to Choussy, the industry can deal with a certain level of fragmentation but challenges are downstream, where the regulatory reporting requirements are, as the regulators do want consistency and standardisation. “The regulatory requirements are definitely encouraging standardisation of reporting and are also encouraging the use of integrated platforms that can consolidate, normalise and then standardise the data, back to the trade repository.”

LEVERAGING EXISTING FUNCTIONALITY

NEX Regulatory Reporting can provide this service, while still allowing for the individual upstream clients to actually retain some of the flexibility and idiosyncrasies within their systems. So, while a lot of the regulatory reporting requirements force standardisation, it is done in such a way that market participants are utilising the likes of NEX Optimisation to normalise the data, and standardise it for them, back to the trade repository. “We try to make it as painless as possible for the end-client.”

Automation is still a cornerstone of the post-trade arena, as is the need to avoid duplication of effort. Says Choussy: “The end client also does not want multiple providers and vendors providing services – in our case, if the client is already sending us the trade data, via Traiana, to perform matching, to perform allocations and confirmations, they would then expect that we take that through to the trade repository to cut down the need for them to connect to multiple providers for the regulatory reporting piece.”

But although there is greater automation in the post-trade FX market, there is also greater complexity. This is inversely effecting cost, and at this point in time, Choussy believes the regulatory costs have gotten the better of that equation. “Whether you are a bank, a hedge fund or an asset manager, compared to a decade ago, it is probably costlier to be in the FX market today because of the operational, capital, settlement and the funding related costs. NEX Optimisation, will enables banks and buyside clients to address each of these issues and generate savings through the use of an integrated solution that leverages our existing functionality and the existing processes, and data that we are already collecting for our clients.”

A NEW MODEL

As the FX market continues to grow and cross-border transactions increase in size and value, so too does the expectation of customers in terms of lower costs and better services. A whitepaper, published in April this year by Broadridge and GFT, examines the idea that a wholly different model for the FX market is needed; whether a possible reshaping of the FX operations market, capitalising on mutualisation, would ease the burden of operational pressures and shrinking Return on Equity (ROE) in the $5 trillion a day market.

The two financial services providers have formed an industry working group to define a future state model, and the paper, entitled ‘FX Operations: the next frontier for mutualisation’, provides what could be a blueprint for mutualisation via a ‘full-service’ managed service provider (MSP), or a common utility for operational functions.

Chris Davis, Vice President of Global Sales at Broadridge Financial Solutions, says that higher levels of automation in trade execution, combined with lower transaction values and tighter margins are forcing a complete re-think of post trade processing technology and operations for FX. He says; “Any time a low value, low margin trade needs to be touched by a human being through manual intervention, any profit is almost immediately lost. As a result, FX players need to automate every stage in the processing lifecycle; they need to consider artificial intelligence tools to eliminate any manual intervention in the trade processing lifecycle.”
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Despite the fact the FX market was one of the first to embrace digitisation, as trade execution was automated, in the complex global FX market, spanning multiple market segments across buy side, multi-national corporations, retail brokers, and individuals traders, the product dynamics make ‘standardisation’ a challenge. However, Davis says that Broadridge has successfully helped businesses move to centralised post trade processing models in other asset classes and while there are some idiosyncrasies in FX to consider, sees no reason why FX could not follow a similar path.

“The Broadridge/GFT white paper argues that the FX market is already behind equities, derivatives and fixed income in the adoption of centralised managed services, offering operational resources on top of a technology platform. The blueprint that the paper lays out proposes a way in which the FX market could actually leapfrog the other asset classes in terms of stripping away the causes of breaks, or unmatched trades, and late payments with a single processing platform for the industry.”

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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, the proponents of the white paper say that a centralised, mutualised operations model, covering both CLS and non-CLS transactions, could empower transformation aimed directly at the costly inefficiencies that exist in the FX operational model today.