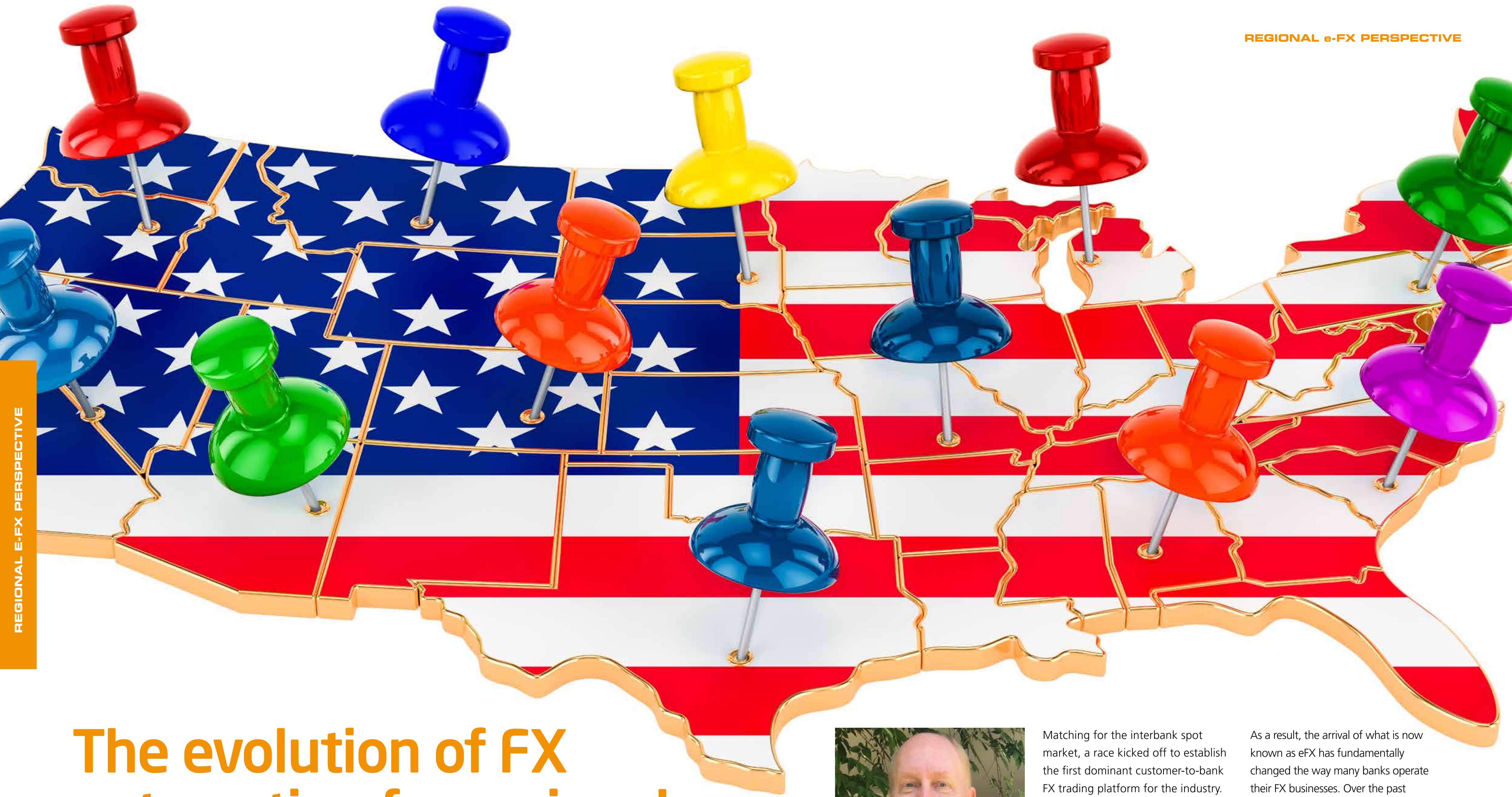
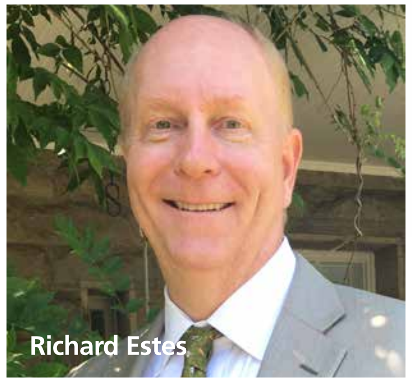


The evolution of FX automation for regional banks in the U.S.

By Richard Estes, Founder and President of eFX Consulting


Richard Estes

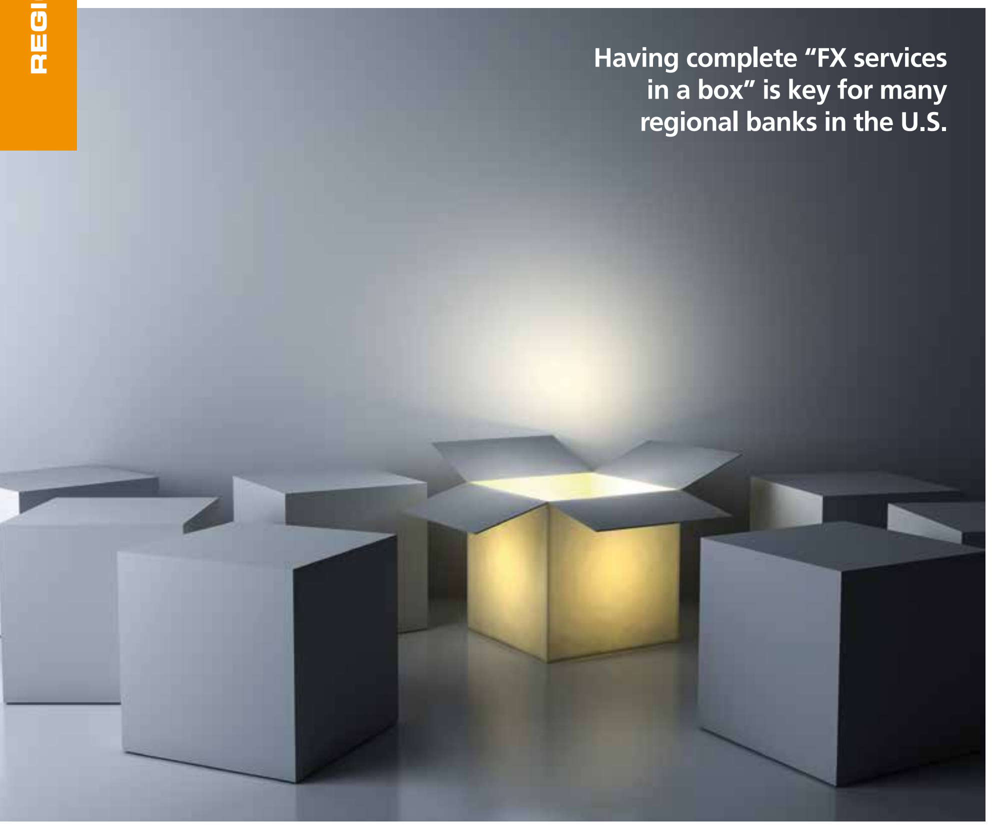
Twenty years ago, the foreign exchange market entered the dawn of electronic trading. Several years after the launch of EBS and Reuters Matching for the interbank spot market, a race kicked off to establish the first dominant customer-to-bank FX trading platform for the industry. The establishment of FX electronic trading platforms such as FXall, FX Connect, Currenex, 360T, Bloomberg, and many others over the proceeding years has had a profound effect upon the FX market. Notably, it has impacted how many end-users such as corporations, asset managers, hedge funds, and others trade with their banks and other liquidity providers.

As a result, the arrival of what is now known as eFX has fundamentally changed the way many banks operate their FX businesses. Over the past two decades FX has changed from a predominantly manual business to one that is highly automated, with eFX capabilities such as liquidity aggregation, price generation and distribution, algorithmic execution, risk management, and performance analytics necessary in order to operate in today's FX market.

However, regional banks in the U.S., commonly referred to as "Tier 3 banks", have been slow to acquire and implement such eFX capabilities. Consequently, their FX businesses still operate much more manually than those of the Tier 1 and 2 banks. For one, U.S. regional banks have not been required to automate in the same way as their customers typically transact FX on a relationship basis, using a bank where they maintain their core banking activities. For another, their FX revenues are a fraction of what they are for the Tier 1 and 2 banks, due to the much lower customer volumes. As a result, there has been both a lack of motivation and resources to invest in the necessary eFX capabilities and associated integration.

U.S. regional banks, though, are at a crossroads today. Some of them are experiencing a handful of customers moving some or all of their FX activity from bank relationship channels to more competitive industry platforms, where automated pricing is essential in order to protect customer wallet share. To provide automated pricing on FXall, Bloomberg, or 360T, they have made basic investments in eFX technology but operate it on a standalone basis without proper integration into the rest of their FX trading workflow. Meanwhile, the underlying driver of their FX activity – cross-border payments - is being threatened by non-bank FinTech payments providers who are offering much more competitive FX rates on smaller-value transactions.

Fortunately, there are technology providers who are now focusing now on servicing this segment of the FX market who can provide both the full functionality and integration of eFX capabilities, and at a reasonable cost. The challenge for U.S. regional banks is determining the right solution for their mix of customer business and legacy technology.



SOURCES OF U.S. REGIONAL BANK FX TRADING ACTIVITY

In servicing the FX needs of the world's largest companies, as well as those of asset managers, hedge funds,


Steve Jacobellis

and other financial institutions, Tier 1 and 2 banks offer FX trading not only for transactional purposes (e.g., payments and securities settlement) and risk management purposes (e.g., hedging), but also as an outright asset class. However, the FX trading of U.S. regional banks is chiefly driven by transactional purposes of their customers, namely small- and medium-sized businesses engaged in cross-border trade.

Over the years as more and more companies have begun importing and exporting goods and services, this has provided an opportunity for U.S. regional banks located near these companies to expand their relationships beyond core banking and lending services into International Banking services to support them, both broadening the relationships and adding higher margin products to them. Such services include International Treasury Management, Trade Finance, and Foreign Exchange.

International Treasury Management services account for the bulk of a regional bank's FX activities, with cross-border payments comprising the largest component. Says Steve Jacobellis, an industry consultant specializing in banking and capital markets and a former FX trader


Cole Augustine

at a U.S. regional bank, "These banks generate most of their FX revenues from their payments activity". Cross-border payments are a natural extension of a customer's relationship with a bank that provides core banking services, as payments are normally pre-funded from the customer's DDA. Some larger regional banks offer foreign currency accounts which enable customers to receive payments in a foreign currency and use the proceeds to fund future expenses in that currency.

Trade Finance services typically do not generate FX transactions for U.S. companies, due to the fact that Import, Export, and Standby Letters of Credit are primarily denominated in U.S. dollars. However, they play an important part in the overall credit relationship with customers, one which can lead to a Foreign Exchange trading relationship for risk management purposes.

Foreign Exchange is a growing part of International Banking services, with many U.S. regional banks touting their capabilities in Spot, Forwards, Window Forwards, and Swaps. Focusing on a basic list of trading products, which have been standard in the FX industry for decades, appears overly simplistic at first. However, for many small- and medium-sized companies only familiar with making cross-border payments, these products are not so basic as they contain a credit provision component.

Providing Foreign Exchange services requires a minimal but significant investment in people, beyond what is typically needed to provide FX transactional services for cross-border payments. Traders are required for pricing, risk management, and nostro account funding; salespeople or "advisors" for customer guidance and assistance with trade execution; operations staff for trade processing, confirmation, and settlement; and credit and compliance staff to support the business. Noting this, Jacobellis adds, "U.S. regional banks' FX desks are staffed to support what are considered more sophisticated trades even if they don't necessarily execute large volumes of them."

EVOLUTION OF CROSS-BORDER PAYMENTS CAPABILITIES

Historically, most U.S. regional banks lacked the proper payments infrastructure to provide cross-border payments capabilities for their customers. Instead, the existing domestic payments infrastructure included different back office systems implemented by a regional bank to support individual banking functions such as wire transfers, ACH, check clearing, lockbox, loans, and information reporting. To support the need to make cross-border payments, many of them outsourced the activity to a larger correspondent bank, including the profitable FX conversion.

Over time, however, U.S. regional banks have upgraded their payments infrastructure by implementing a core payments platform which included the ability to handle non-USD payments. Examples of such platforms include Finastra's Global PAYplus, ACI Worldwide, and Fiserv's WireXChange, states Cole Augustine, founder of Galactic Trade Consultants and who has worked in Treasury Management and International Banking roles at several U.S. regional banks during his career. While these systems have provided more control over initiating cross-border payments, they still have left many U.S. regional banks dependent upon the FX capabilities of their correspondent bank partner, including the supply of daily static FX rates.

As their cross-border payments volumes have grown, and with it revenue opportunities, the larger U.S. regional banks have implemented separate FX trading platforms which offer a core FX front office and back office along with a web-based customer front end, include Finastra's Fusion Opics, ION Group's Wallstreet FX, CGI's FXSuite 360, Calypso FX, Broadridge FX, and Finzly's FX STAR. The addition of an FX platform, complete with payment workflows, has enabled these banks to shift their larger cross-border payments activity to it, thus consolidating its FX trading activities, adds Augustine.

Having complete "FX services in a box" is vital for U.S. regional banks, which have limited IT budget and resources to support their FX businesses and often cannot afford to acquire and integrate separate front- and back-end components. Concludes Augustine, "The driver in choosing [a vendor system] is often the customer front-end. [These banks] also have little desire to build a pricing engine for it, relying instead on their correspondent banks to provide an FX rate feed".

Support for an FX rate feed is an increasingly important consideration, as the use of real-time FX pricing for

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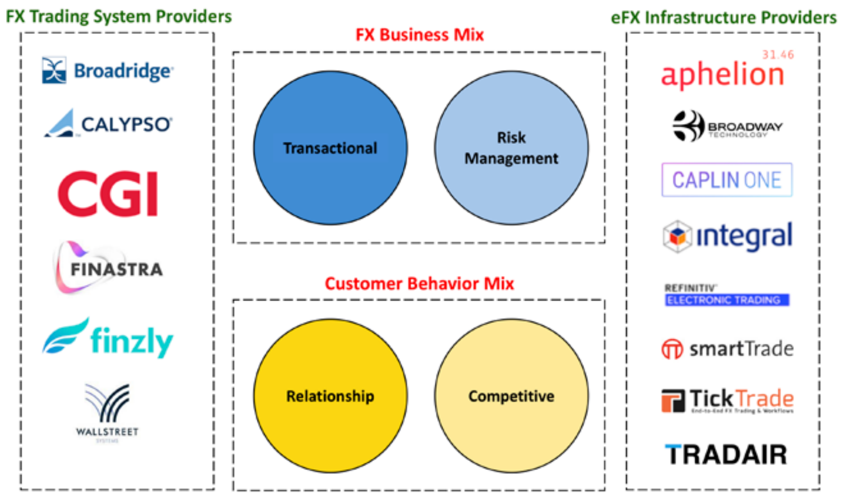

Regional Bank FX Automation Solutions

cross-border payments now mimics how FX is customarily traded. Finzly, for one, has recognized the need to provide real-time core market pricing and risk offset tools for banks who lack any eFX infrastructure. It offers in FX STAR a configurable pricing engine that supports both RFQ and RFS pricing, as well as liquidity provision from FX SpotStream or Bloomberg's FXGO for auto quote and cover. CGI's FXSuite 360 also includes an integrated liquidity management engine with options for liquidity provision via FXSpotStream or from select Tier 1 banks.

INCORPORATING EFX INFRASTRUCTURE

Relying on one of these all-encompassing FX trading solutions is sufficient for servicing the transactional and other basic FX trading needs of a U.S. regional bank's customers who exclusively use the bank's relationship-based channels. But what happens when some of them ask that bank to trade with them via FXall, 360T, or Bloomberg? Here the bank needs to consider employing additional eFX infrastructure to support these customers, minimally for price generation and distribution but potentially as well for liquidity aggregation, position management, and other features.

Providing FX services requires a significant investment in people

There are numerous options for a U.S. regional bank to consider, as an increasing number of firms are offering hosted eFX services that can be provided modularly or in entirety depending on needs and budget. A number of the established market leaders, such as Refinitiv (Electronic Trading), Integral (Bank FX), Aphelion (Aphelion eFX), and TradAir, initially designed core eFX infrastructure for top tier banks, but now find regional banks to be a major segment of their customer base. Similarly, firms such as Broadway Technology and smartTrade (LiquidityFX), who first developed sophisticated e-trading tools for Tier 1 banks, are now looking to move down market and offer their services to regional banks.

Meanwhile, TickTrade, founded more recently by a cadre of former regional bank eFX specialists, is focused on supporting the specific needs of U.S. regional banks, with separate modules for eFX infrastructure and for global payments. Finally, Caplin Systems, a longtime market leader in HTML5-based web front ends for banks, has rolled out basic e-trading capabilities via its Caplin One product.

PAYMENTS PROVIDERS AS BOTH A THREAT AND OPPORTUNITY

As the payments business is considered as one of the last profitable areas of FX, there have been significant efforts by numerous non-bank payment providers to take this business from regional banks by offering much more competitive FX pricing for cross-border payments,

even for smaller value payments. One advantage these providers possess is their foreign currency account infrastructure across an extensive correspondent bank network that allows them to separate the FX trade component from the payment transaction. A regional bank, meanwhile, may be limited to using its correspondent bank for payment delivery as its sole FX counterparty.

Interestingly, some FinTech firms provide multi-currency account infrastructure to enable smaller regional banks to offer cross-border payment capabilities with competitive FX rates without having to maintain correspondent bank relationships. One such firm, Currencycloud, also supports virtual named accounts for a regional bank's customers without the need to complete extensive documentation for actual physical accounts.

DETERMINING THE RIGHT APPROACH TO AUTOMATING FX

U.S. regional banks earn just a fraction of the FX revenues of Tier 1 and 2 banks. As a result, their investment capability in FX systems and automation is limited. Still, for a bank whose overall revenues are in the millions, not billions, of dollars, additional revenues from FX activity can be meaningful to the bottom line. "We see regional banks bringing FX business in-house as they see growing demand and the non-interest income opportunity available. They can earn millions in FX revenue in a very short period of time", says Brian Anderson, Vice President of Business Development at Finzly.

The challenge, therefore, is to determine the right approach to choosing technology solutions to support and ultimately automate a bank's FX business. Important factors include the mix of transactional- versus risk management-related FX, and the use of relationship channels versus industry platforms by customers. For many U.S. regional banks, depending simply on a comprehensive FX trading platform may be sufficient to operate a purely relationship business. However, the addition of an appropriate-sized eFX infrastructure, with proper integration to an FX trading platform, can provide additional benefits to improve the efficiency and profitability of the business. Technology firms, thankfully, have recognized the need to package eFX functionality with integration services, running in cloud-based environments that can be provided to smaller banks at reasonable costs.