Outsourcing Risk Management:

Assessing the benefits for a critical component of the FX Workflow

SaaS business models have changed the way banks look at their businesses. Is institutional FX risk management a candidate for disruption too? Vivek Shankar explores the issues.

Technology is changing the way businesses function and is shifting attitudes with it. While technological impact has made itself rather obvious in consumer finance, even institutional finance has been rapidly remodeling itself around changing consumer attitudes.

Deloitte's "Bank of 2030: Transform Boldly" highlights the need for banks to reorient themselves around emerging technology, embrace operational agility, and leverage the power of analytics to drive their businesses further. When put together, all of these initiatives help banks place their customers at the center of their business strategies.

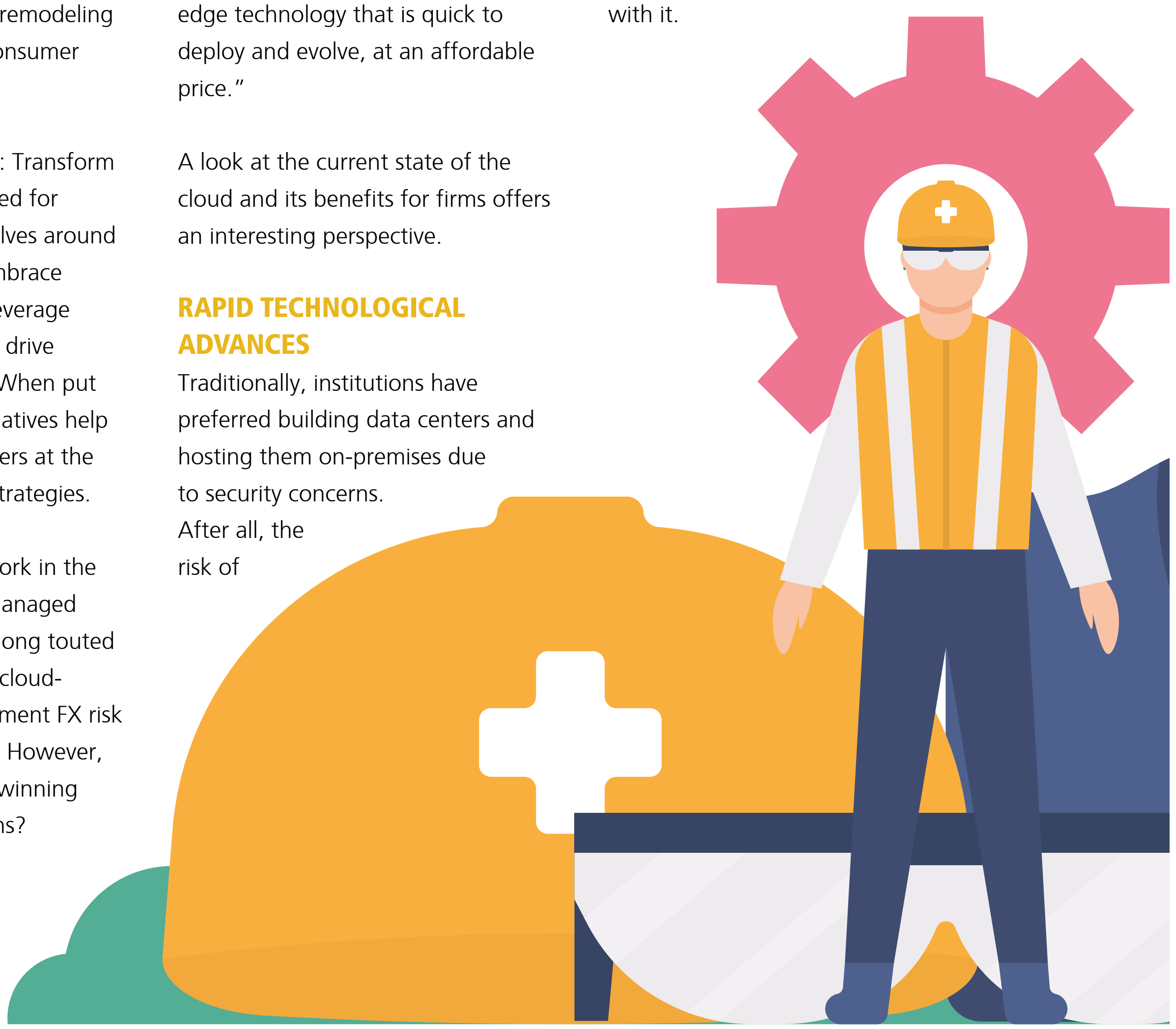
Can such an approach work in the institutional FX world? Managed services businesses have long touted the benefits of adopting cloud-based technology to augment FX risk management workflows. However, is a move to the cloud a winning proposition for institutions?

Vikas Srivastava, Chief Revenue Officer at cloud-based financial technology provider Integral Development Corp. thinks so. "The benefits of cloud computing for the FX risk management workflows are many, but the principal advantage to users is the ability to access cutting-edge technology that is quick to deploy and evolve, at an affordable price."

A look at the current state of the cloud and its benefits for firms offers an interesting perspective.

RAPID TECHNOLOGICAL ADVANCES

Traditionally, institutions have preferred building data centers and hosting them on-premises due to security concerns. After all, the risk of exposing order flow was significant, and it was easier to house a technology team that could address infrastructure and security concerns. However, this setup brought problems with it.



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"For most banks, credit management, price-making, internalization, and hedging customer flow were still manual rather than automated tasks," says Srivastava. "Often, by the time this technology was built, it became out of date given the rapidly evolving nature of the markets."

Technology has made rapid strides, and institutional attitudes have been changing. A survey conducted by FX Markets and Integral discovered that 41% of respondents expected to house FX trading workflows on a hybrid model of cloud and on-premises technology. A further 28% expected their workflows to be entirely cloud-based within five years.

Cloud infrastructure these days allows institutions to host their data on public or private clouds, communicate that data to other applications seamlessly, and archive it. Add to this the security-centric focus that cloud services providers include in their offerings, and the benefits become obvious.

Cost-effectiveness is the biggest benefit of moving to the cloud. FX market environments change constantly, and banks need rapid adjustments in their risk management workflows. Such conditions call for a nimble technology stack, and the cloud is a perfect fit. Thanks to fast deployment features and easily updated components, institutions can integrate, scale, and configure their applications with low risk.

Cloud technology also allows banks better integration between pricing and risk management workflows. Institutions can build intelligent feedback loops between these functions these days using managed services.

For instance, banks can skew their pricing according to their risk appetite and adjust their strategies upon meeting P&L targets. These features allow banks to automate workflows between pricing, credit, and risk management. Traders can customize their risk management strategies, whether they wish to implement time-based, event-based, passive or active hedging, or algorithmic order management.

Internalizing order flow to mitigate high hedging costs in the market is also easy when opting for a managed service provider. These features will appeal especially to banks and retail brokers. Cloud-based service providers offer dealers high levels of flexibility by allowing them to customize their warehousing models. They can automate their workflows or manually manage risk, with the option to switch back and forth in real-time.

Finally, one of the biggest benefits that a cloud services provider can offer is the ability to dig deeply into transaction data. The FX market is full of valuable data, and analytics can power better decisions. In the past, banks would have had to rely on building proprietary analytics software.

However, these days off-the-shelf software allows them to plug their data pipelines into these platforms and immediately view trends and TCA models on their data. These sophisticated platforms help banks build better risk management strategies that react to real-time data in the market. Thus, banks can now zoom in on tick level data and receive a holistic view of their risk management models.

These benefits offer FX dealing institutions an easy way to modernize their businesses with no disruption to services. Despite these benefits, there are some issues banks must consider before going down the cloud route.

KEY ISSUES TO CONSIDER

"There are a host of critical considerations in picking the best SaaS providers in FX," explains Srivastava. "These relate to both qualitative evaluations, associated with experience, customer service and flexibility of technology, and quantifiable traits, such as costs and time to market."

Traditionally, outsourcing services have required clients to sacrifice some control over business processes, but this isn't the case with a good managed services provider. Service providers manage data connectivity and make sure that a dealing desk is receiving all the information it needs to manage risk. They don't manipulate or control the data itself.

In essence, a good risk management services provider must be an extension of the trading desk's infrastructure. They must help firms build better trading strategies by giving them the tools to react to changing conditions faster. These days, volatility events are a common occurrence, and during such times the flexibility a managed services provider offers can be invaluable.

The ability to preserve trading connectivity, whether it's finding liquidity partners or maintaining data flow, through any means necessary is a critical requirement. A good managed services provider evaluates all possible use cases to connect a bank to its counterparties. Whether by voice, RFQ, or a central limit order book, the more avenues a service provider offers, the easier it becomes for banks to deal with adverse market conditions.

Every managed services provider offers a liquidity community to its clients, thanks to better connectivity. Some institutions might reevaluate their risk models because of this. For instance, fund management firms have to source large pools of liquidity to protect investor funds and preserve the effectiveness of their strategies.

A DIY approach will cost the firm significant resources and time, which increases the risk on their books. By outsourcing services, these firms can reevaluate their position in the markets thanks to greater liquidity access. Evaluating this liquidity community that a services provider brings is crucial.

The primary service a managed services provider offers is data flow. While real-time data is important, access to in-depth historical data is critical since it allows desks to build accurate benchmarks. Reacting to liquidity events and stressed market conditions becomes easier as a result.

The bottom line is that a managed services supplier must be service-oriented and accommodate an institution's regulatory and compliance requirements. They must be prepared for the long haul technologically since the markets are changing quickly. Banks must review service level agreements (SLAs) to enforce liability, resilience, and security in the services they receive.

"Being a trusted partner is a frequently overused term," opines Srivastava. "However, keeping customers' best interests at heart and helping them achieve the best outcomes come from taking the long view with them, assuming that they will be serving customers for several years, if not decades. That trust comes from genuinely listening to actual problems and finding the right solutions."

Each firm's connectivity requirements will differ depending on their trading strategies and banks must take the time to discuss and validate the kind of service they need before engaging a service provider.

TAILORED SOLUTIONS

Managed services providers differentiate themselves by offering clients the ability to customize the solutions they need. For instance, risk management requirements differ for the buy and sell side. The sell side needs greater focus on regulatory requirements, client demands, and keeping pace with product changes. Of course, the size of a firm also determines the depth of focus on these areas.

The buy side might focus more on achieving the best execution which means gaining access to different types of liquidity, whether through bank relationships or non-bank market makers. Their risk management systems will also need to fit seamlessly within their order lifecycle and OMS platforms. Traders at these firms might want to upload multiple orders at once and view the risk consequences on their books in real-time.

"Risk management in the current market is all about micro focus, being able to customize down to the smallest level as well as managing risk on the aggregate level," explains Srivastava. "A good cloud provider allows you to do that with the correct configuration of your systems."

Service providers offer a range of solutions, aside from broad services like a public, private, or hybrid cloud. No matter the client's requirement or size, the cloud offers firms the best way of scaling solutions to their needs due to its flexible nature.

CONSTANT INNOVATION

The SaaS business model has disrupted the way businesses look at their technology platforms, and risk management is no different. Firms that adopt the cloud tend to innovate faster and develop flexibility in their operations.

While outsourcing every aspect of FX order flow to the cloud isn't the best solution yet, there's no doubt that the benefits of hosting risk management processes on a third party platform are immense. From tailored solutions to advanced data analytics, managed services providers offer a suite of solutions that benefit institutions of all sizes.

While the kind of services offered to institutions will change, the cloud is here to stay, and its influence is growing in institutional FX. Srivastava believes that a complete move to the cloud is inevitable.