

FX Liquidity Management:

Should you be taking a more proactive approach?



By Roger Aitken

The topic of Liquidity Management across the capital markets and in the FX space in particular has received a growing level of attention over recent years as innovation has allowed technology to meet the complex Liquidity requirements of banks and financial institutions, thus helping to deliver efficiencies and mitigate risk. Roger Aitken talks to some leading technology vendors to find out more about the latest developments within this space.

Definitions

The definition and applications relating to Liquidity Management have prompted a considerable amount of debate. Various market participants have used it as a catchall term, with the meaning interpreted slightly differently depending on who one canvasses. However, whichever way you choose to define it, having a sound FX Liquidity Management structure in place helps to ensure that trading opportunities can be more effectively grasped and risks more efficiently managed. It also makes even more sense in terms of institutions when they are operating globally and managing FX rates and Liquidity internally and for their external clients.

With regard to key applications including Liquidity Aggregation, CEP and Smart Order Routing, one definition of Liquidity Management might be to regard it as the “science of automatically managing market and resting order flow with minimum human intervention”, according to Yaacov Heidingsfeld, CEO and co-founder of TraderTools Inc., a New York-based provider of software and services to financial institutions specifically trading FX.



He adds: “Liquidity Management from TraderTools’ perspective means: Am I looking at all my currency exposure from all the sources of my supply and demand simultaneously – in real time and electronically? With the volume of trades in the FX market and ballooning tickets it’s worth bearing in mind that this is a key requirement can no longer be performed manually.”

Examining LM architectures

TraderTools’ Liquidity Management Platform™ is offered up as one of the only systems on the market today that integrates the “four disciplines” of electronic FX trading, namely: an FX Pricing Engine, FX Liquidity Aggregation, FX order Management and FX White-Labeling.

“These are the four key elements of any system that any bank trading in FX requires,” states Heidingsfeld in New York. “But the fundamental question is really: As a bank are you buying all of those elements from a single vendor, or are you looking to use certain elements that you already have. Moreover, even if the system components are disparate, the overall Liquidity Management Strategy (LMS) should be unified.”

More flexible Aggregation solutions

Looking at initiatives leading vendors have been taking of late to make FX Liquidity Aggregation solutions more flexible in order to help in the optimisation of flows and to deliver more compelling competitive advantages, much has been happening.

Heidingsfeld at TraderTools, says: “As a technology vendor wholly-focused on FX, we deliver an open system, whereby if a potential customer has an existing LMS technology they wish to integrate, we can do that for them. As such, it does not have to be an ‘all or nothing approach’ where customers are held hostage to a particular offering.”

He adds: “Given that our licensing model is transaction-based, end-clients have all the technology [LMS solutions] available to them. They’re able to decide which components and solutions they wish to select and compare the results in real time.”

And, in terms of ROI, Heidingsfeld says that TraderTools has a “proven model that objectively demonstrates increased revenue streams” for banks deploying its Liquidity Management solutions. According to Heidingsfeld, one unnamed bank client has been able to save around \$75 per \$1m worth of FX volume traded through just two aspects – FX Liquidity Aggregation and FX Order Management. “And when our FX Pricing Engine and FX White- Labeling modules are activated, that number could be much higher,” he adds.

Distribution strategies

Turning to steps that financial institutions can take to develop more effective distribution strategies for FX Liquidity, banks will usually either have a white label e-Commerce platform or their own single dealer platform.

Heidingsfeld adds: “To me, more effective distribution strategies in FX trading all really revolve around more effective pricing. Essentially, there really are no more than three ways to distribute prices to a bank’s customers: (1) an FX White-Labeling solution, which most institutions have adopted and are looking to upgrade; (2) a Multi-Bank Portal; and, (3) a FIX API to the customer.

The method a bank chooses depends on its size and customer base.” However, he goes on, “Regardless of the channel, they have to ask whether they are making the best possible prices and offering razor-sharp prices for different customer profiles.”



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Connectivity and Latency issues

Latency is clearly a key issue to be solved. Banks often ensure this is minimised by having three separate instances of their price distribution system – each one serving the clients in the global region. With new vendors entering the connectivity space to compete with the traditional providers, improvements in connectivity speed are continuous.

Heidingsfeld says that latency and scalability are two areas that highlight both the challenge and promise of LMS systems. “The more the integration points and disparate technology, the greater the latency. Liquidity, as well as system optimization, should be measured across the entire FX platform. Because when the technology is closely integrated, the LMS solutions can really shine.” He adds: “the whole concept of Liquidity Management is still relatively new and has essentially grown up over the past 12-18 months. There aren’t many true LMS systems available on the market today.”

TraderTools is one vendor that starts conversations with banks about the individual modules that make up an overall LMS architecture – based on their immediate pain points.

“While some of these institutions already have Risk Management systems processing FX trades end-to-end, the issues really centre on whether they can process the information and flow required, fast enough to extract the value they need.”

CASE STUDY

BayernLB deploys a Liquidity Management platform

BayernLB is the leading Bavarian commercial bank for large and middle-market corporate customers in Germany and Europe. One unit within the bank that has consistently outperformed over the past few years is the FX trading department, headed by Marc Burgheim. Although profitable, the unit is still largely based on manual trading.

Automation is the Challenge

Marc knew that FX trading was providing stable earnings for the bank. But he also knew that those earnings “could be increased with the right investment.” The right technology was the answer. If much of the FX trading could be automated, Bayern would be able to offer better prices, more Liquidity and quicker response times than any other bank in its peer group.

Step 1 was Aggregation, in order to reduce spreads and increase profitability. Step 2 was full STP, in order to be able to increase trading in Options and Emerging Markets.

Marc checked out various Aggregation tools as well as ECNs with Aggregation functionality. The problem was that each one of these solutions would have to be integrated with additional tools in the future (i.e. to handle algorithmic trading or auto-hedging).

Integration is the Answer

After a relatively short, evaluation period the TraderTools' Liquidity Management Platform™ (LMP) was chosen and went live in the Bayern FX trading room.

With manual trading, it is humanly possible to handle only 2 or 3 Liquidity sources at a time. Now Bayern FX traders are “more than happy” being able to stream 5 or more separate Liquidity sources at a time.

“What sold us on TraderTools was the fact that its LMP offered a lot more functionality than just Aggregation,” explained Marc. “We’re looking forward to activating algorithmic trading and auto-hedging functionality in the near future.”