MillTechFX
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The Fund Manager's Guide to FX-as-a-Service

How to automate, outsource & futureproof FX execution

By Joe McKenna

Introduction

A common theme in private capital right now is fund managers seeking out opportunities to outsource non-core activities as they build for scale. Even for those processes that would be considered ‘core’, there may also be opportunities to automate, improve efficiency and eradicate operational risk.

For a first-time manager, they might look at FX as a process, from start to finish, that places a disproportionate amount of strain on their finance function.

Fiduciaries must implement a multi- FX counterparty framework that delivers best execution and to get to that point alone can place huge demands on different teams across the business including finance, compliance, legal and, depending on the resources within those business units, the partners.

The obvious question being, shouldn’t the majority of resources be focused on fundraising, deal sourcing and establishing a track record?

For a more well-established manager, they’ve long since overcome these initial hurdles. Although legacy FX infrastructure systems and processes that continue to place skewed demands on the finance team might prevail. My favourite (real life) example is of a private equity manager’s CFO who used to head off to a meeting room with two colleagues every time they needed to book an FX trade. They would each call a different bank to get a quote and then the best quote would win. The team would then head back to their desks to await trade confirmations before arranging settlement, entering and cross-checking payment details, manage regulatory reporting and looping in their fund administrator.

The PE manager wasn’t just bogged down in manual processes, but it also increased the likelihood of errors.

It’s easy to see that similar operating models aren’t sustainable in a flexible working environment which is why digitisation of treasury processes has moved up the ladder of priorities for many fund managers.

A fund manager should also consider future-proofing their finance function – in five years’ time, there may have been more than two new funds raised, a larger pool of capital and investments to oversee, new strategies, new jurisdictions, new investors and new employees in the team. Archaic processes might be a minor annoyance today but could become a significant operational overhead in the future. As any organisation scales, the bandwidth to make changes diminishes, placing even more importance on selecting service providers today that can grow with your business and who prioritise innovation.

Need vs. Wants

In my opinion, there is only one thing a fund manager must achieve from their FX execution set up and that is best execution. In short, this demands that a fiduciary takes all sufficient steps to get the best possible result for their client, and a fund managers clients are their investors. What this looks like in practice however is up for debate, but at the very least a fund manager must have more than one FX counterparty in competition for every trade, and ideally three or more.

However, as any fund manager with an FX exposure will know, the quest for best execution is littered with inefficiencies and ongoing operational drag. From this single regulatory requirement springs a litany of new hurdles and considerations.

Further, many private capital fund managers, particularly those in PE, credit, infrastructure or real estate adopt the same, vanilla hedging strategy.

Whether its share class hedging or a rolling NAV hedge, using quarterly rolls is commonplace, leaving many managers thinking ‘surely this can be automated?’

Setup

The search for eligible FX counterparties might logically start with incumbent banking relationships, and custodians, prime brokers or lenders may be able to offer FX trading services. Where it gets challenging is establishing new relationships for FX only, as there is no guarantee a bank will want to onboard a client that only requires one of their services.

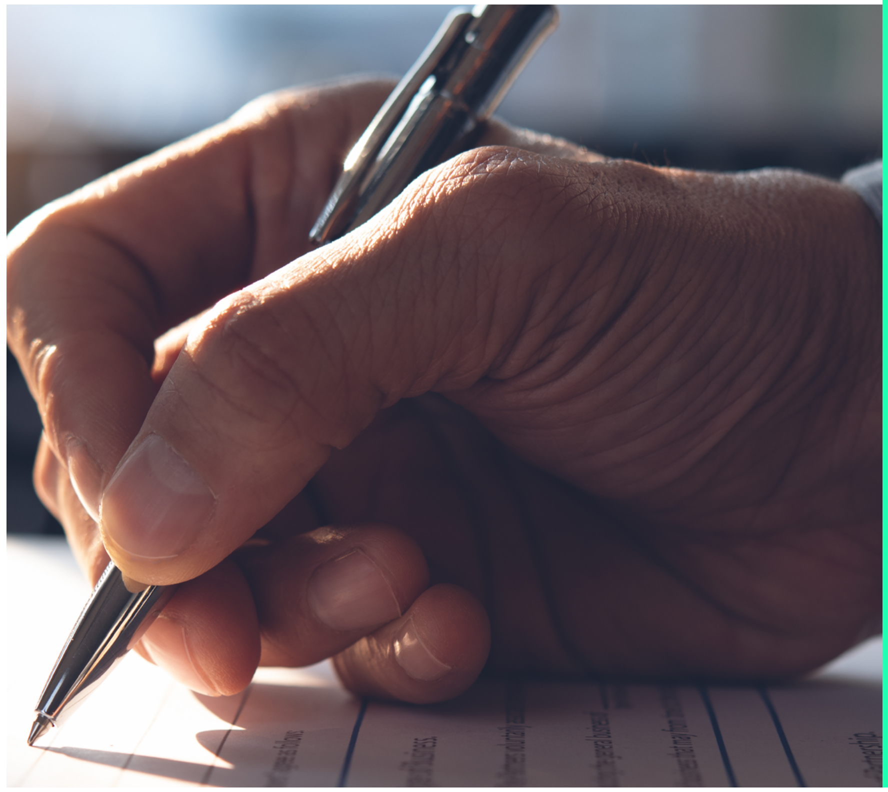
And then there's the setup phase:

• After negotiating the finer points of a non-disclosure agreement, a GP must fill out paperwork, locate and share 'know-your-customer' documents and then go through a credit approval process.

• Credit approval can be particularly challenging; expect your chosen counterparties to look through investor commitments and underlying assets with a fine-tooth comb.

• Respective legal teams will need to work through ISDAs, CSAs and any other trading agreements before setup.

The setup phase places huge demands on internal resources, so the private capital market is moving towards outsourced solutions that onboard the fund manager with multiple banking counterparties and also get credit facilities approved with each bank simultaneously.



Price Discovery

Once setup is complete, the process of price discovery can happen in a number of different ways:

• Telephone dealing

• Onscreen quotes

• Chat messages

• E-mails

With multiple counterparties at a fund managers' disposal, it can soon turn into a time-consuming, team operation to get the best available price.

Depending on how a fund manager goes about price discovery, there might be a tradeoff between inefficient booking systems versus the number of counterparties.

When collecting quotes for a trade, a fund manager might defer to an FX advisor who can help apply some price tension to counterparty banks prior to execution. Alternatively, a fund manager might explore integrating with an aggregator platform that shows a live feed quote from each of their banks, digitally centralised in one place. Both options come at an additional cost and the GP may have to dip into their pocket and pay directly for the service or suffer an increased spread in the FX rate they receive.

Post trade workflow

After a trade has been booked, the remaining workflow might involve trade settlement, onward payment, margining, sharing trade confirmations with fund administrators, transaction cost analysis (TCA) and regulatory reporting (e.g. EMIR / Dodd Frank).

It's worth noting that different banks have different systems and ways of doing things – there may be nuances to every post-trade process depending on the bank.

The post trade workflow requires a high degree of accuracy. If any steps are missed or any data input incorrectly, it can set off a chain of events that is even more time consuming and pulls in extra resources.

The most desirable option for a fund manager is to integrate with a system that can link in with custodians and fund administrators that also automates regulatory reporting and TCA. Such solutions save time, support flexible working, and crucially seek to eliminate errors post-execution.

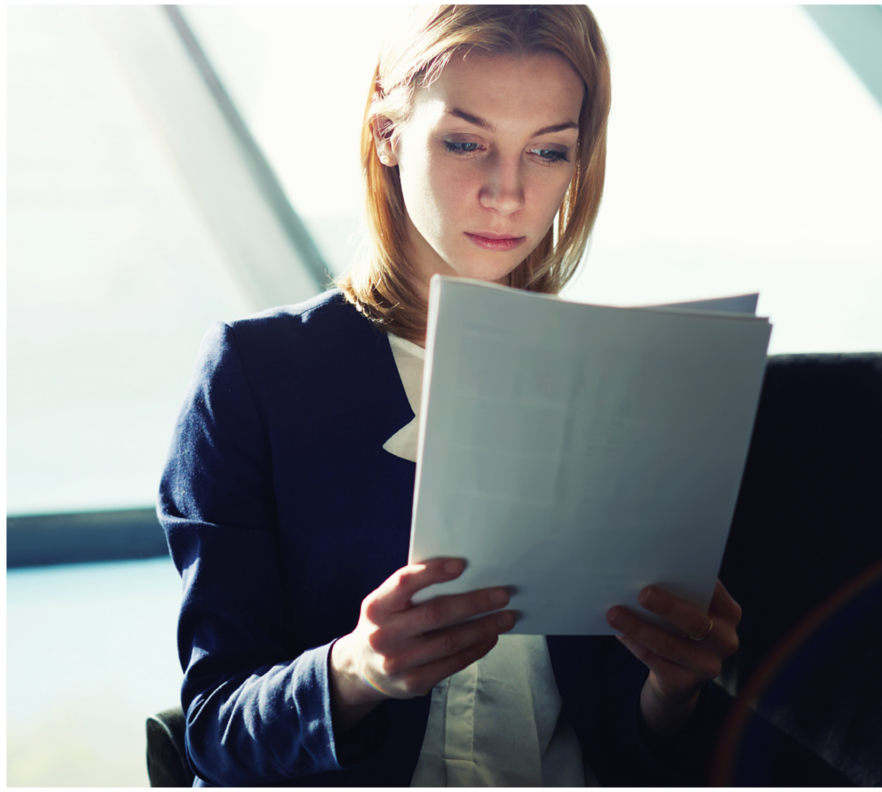
Rolling hedging strategies

When it comes to FX products, fund managers prefer to keep things simple and rarely use anything outside of spot contracts, FX forwards and swaps.

When hedging the portfolio NAV or share classes (on behalf of investors), the most common FX hedging strategy we see is quarterly rolls using swaps. Any adjustments to the hedged amount as a result of investments, divestments, fresh capital or investors exiting, can be made throughout the quarter ensuring the far leg of any new swaps matches pre-existing swap expiry dates.

The strategy is simple and easy to execute - in fact, fund managers can even outsource the execution of these strategies altogether, without even clicking a button.

Whatever operating or accounting systems a fund manager uses internally, any new or adjusted trades can be communicated automatically to whoever they use for execution. As long as their FX provider gives best execution, the fund manager doesn't even need to get involved in the price discovery process, but they would be wise to keep an audit trail with TCA.



Introducing FX-as-a-Service

In Mark Andreesson's 2011 essay 'Why Software Is Eating The World' he cites multiple examples of "businesses and industries that are being run on software and delivered as online services – from movies to agriculture to national defence."

However, there are roadblocks inhibiting the unchecked expansion of software solutions in financial services and FX. For example,

• Banks are heavily regulated, which is a significant barrier to entry.

• In FX specifically, globally recognised trading agreements (e.g., ISDA documentation) usually require legal intervention – the kind that is highly bespoke and therefore awkward to replicate en masse.

Perhaps this means that any software that improves efficiency, especially in financial services, should work with the pre-existing infrastructure, rather than against it. And this is where the idea for FX-as-a-service springs from.

What if, instead of establishing multiple new banking relationships to achieve best execution, a fund manager could instead plug into a pre-existing FX marketplace, with tier 1 liquidity, pricing power through economies of scale, without the need to negotiate new ISDAs, keeping the entire onboarding process as streamlined and doc-lite as possible?

There would be a significant efficiency with setup and price discovery.

Further, what if the solution was tech-enabled, helping to automate post-trade workflow and even the full end-to-end process if a fund manager employs a rolling hedge strategy? The fund manager would have de-risked operationally, given resources back to their finance team and future-proofed the FX process.

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How MillTechFX can help

MillTechFX by Millennium Global is the FinTech affiliate of Millennium Global Investments, one of the largest specialist currency managers globally. Our multi-bank marketplace helps institutional investors and managers significantly reduce both FX costs and operational burden associated with FX execution and rolling hedging requirements.

We provide an end-to-end solution, from onboarding with up to 15 counterparty banks to execution, settlement and reporting of FX transactions, including TCA, across multiple funds.

To speak to us directly please reach out to Joe McKenna at jmckenna@milltechfx.com.

Marc Andreessen 'Why Software Is Eating The World' – The Wall Street Journal, August 2011 https://osr.cs.fau.de/wp-content/uploads/2016/08/marc.pdf **URN: MT100138**