White-labelling: Why reinvent the wheel?

Christian Bock, managing partner of Consulting for Banking and Brokerage Solutions (CBBS) in Zurich, looks at the benefits of using a white-labelled platform and the issues to consider when choosing one

In recent years, many small and mid-sized banks have not progressed as fast as their clients in the foreign exchange business. Clients have become more savvy and confident while simultaneously losing trust in traditional investment models, and have increased the demand for client-directed FX trading platforms. We estimate that more than $300 billion is transacted daily in the retail market electronically, away from traditional banks. This is being driven by clients' demand for competitive pricing and the wider spreads of many banks caused by costly manual labour. Like the travel industry, where most clients now book their flights on the internet without the advice of a travel agent, FX clients seek direct access to the markets and best price. Small and mid-sized banks have lost clients to electronic commerce competitors as a result, and the question for them is how to respond to this evolution.

Given the spread compression in recent years, it seems hard to justify the fact that sales traders are executing cash tickets manually while they could concentrate their expertise on advisory of products with higher margins, such as structured solutions or derivatives. As in the production of any commodity, human skills should be used mainly in areas that cannot be automated and are therefore generating higher revenues. The conclusion here must be to outsource or streamline the FX cash business by offering it electronically whenever applicable.

In many cases the in-house development of an electronic trading structure will not be the right economic decision, due to the large initial investment and the internal IT specialist knowledge necessary to perform and predict exact go-live dates. Alternatively, in-sourcing of technology from a third party is based on a service level agreement with strict deadlines and guaranteed expense budgets, which will enable clear control of investment and time. This leads many to reconsider the value of re-inventing the wheel.

A number of banks and retail aggregators as well as IT vendors offer a range of white-label solutions, which in most cases can be customised to fit specific external and internal needs. Before deciding on a vendor and set-up, however, it is essential to consider a number of aspects to determine the client services required. These include:

- Which client groups are addressed? Corporate (payment) clients or proprietary trading institutional/retail clients?
- Which cash products must be provided? Will spot be sufficient, or is it also necessary to offer forward outright/swaps?
- Should trading lines be defined by gross settlement, collateral (margin trading) or both?
- Should flow be outsourced, partial or complete?

Some partners offer their infrastructure in exchange for flow, others on a fixed fee or commission basis with minimum wages, and some will leave both options open. The questions to ask here are:

- What are the total costs of producing FX liquidity internally?
- Will it be cheaper to buy this commodity externally?

For many small and mid-sized banks, only certain currencies and time zones offer an efficient netting effect, while others do not. An outsourcing of the non-profitable business to a liquidity provider with more flow who will be able to warehouse in a different – and likely profitable – way is a win-win situation. This will free up in-house resources to concentrate on revenue-generating business.

For all flows that are kept in-house, the necessary electronic pricing can either be purchased from a third party or produced internally, by combining different streams and using algorithms. The advantage of buying externally is clearly the lower cost; the disadvantage is the potentially skewed pricing a provider might stream under certain market conditions.

One aspect that only few vendors are addressing today is the ability to offer derivatives and/or structured products electronically to retail clients – an issue that is likely to become more important in the near future: vanilla options have commoditised, and the demand for directional option trading will increase if the current volatility persists. An increased demand is also to be expected for enhanced money market products in a low interest rate environment.

Depending on the individual needs for customisation of a white-label platform, the pricing will vary significantly. For a bank that decides to outsource all electronic client proprietary spot trading on a margin basis to a single provider, it is likely that the complete infrastructure will be provided at very low or even zero cost in exchange for an estimated flow of around $1 billion per month or more. For more specific needs, like partial warehousing of flows or the capability to process money market transactions, higher costs (and/or required volumes) are to be expected.

Client behaviour and demands have grown such that few banks can allow themselves not to offer e-commerce trading. Markets have evolved in a very favourable way, which allows technological enhancement at a reasonable cost while matching specific individual needs. Part of adapting to this development should, however, be to decide whether to outsource certain products for the sake of others.