Cross-asset trading and risk management

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Abstract

It is no longer acceptable practice for banks and brokers to operate in product silos, it is not only hedge funds but traditional investment managers that need to be able to trade across the different asset classes — equities, derivatives and increasingly FX and commodities. Initially, banks have been bringing together their exchange-traded equities and derivatives operations on a single order management system, but this is going further to include some over-the-counter instruments, and the much needed overlay of foreign exchange transactions. This paper examines the increasing move towards cross-asset trading and the need for trading operations within the same bank to work together to provide a single window for the multi-asset customer.

INTRODUCTION

A more holistic approach to risk management, brought on primarily by the imminent introduction of Basel II, as well as the commercial benefits of a single one-stop shop and the cross-asset margining available at clearing houses, has prompted banks and brokers to rethink how they offer, and margin, products from different asset classes.

Already the global macro hedge funds are trading multi-asset trading portfolios and, while among traditional asset managers the trend towards cross-asset trading may not mean one trader trading all asset classes, there is a move to at least consolidate trading through a single-order management system, to enable a better overview of risk and profit and loss.

Industry players have long anticipated the move to a cross-asset-class business and technology model across the industry. The buy side (particularly the hedge funds), is already leveraging arbitrage opportunities across asset classes, which has spurred the banks to respond by integrating the various asset-class silos. Central to all three pillars of the Basel II Accord is the need to manage risk across the entire enterprise — something that is at the heart of any good risk management policy and what most banks are striving towards internally in order to reap the benefits of more prudent management of collateral.

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To achieve this, banks first need to centralise data from all areas of banking activity. This alone is a huge task, given that product silos have naturally grown up within banks. And even if managers are able to manage risk across different silos, such as exchange-traded derivatives and equities, there are still the banking book transactions to be considered, as well as over-the-counter transactions. Already many banks are netting internally, either by central counterparty or at customer level, in an attempt to value portfolios across asset classes. Basel II will further force managers to quantify and understand risk down to book level.

Nicolas Breteau, CEO of Fimat UK, says: 'Our customers want to combine their assets and liabilities in one place in order to reduce the collateral requirements. They expect to use their long assets as collateral for their liabilities or against margin requirements.' He anticipates a growing demand for a global portfolio approach, not only from traditional clients such as financial institutions — driven by the need for optimised capital allocation and cost-efficient solutions — but also from funds and market makers wanting to benefit from cross-margining in order to limit the amount of capital needed to conduct their strategies.

CLEARING LEADS THE WAY

Another factor prompting the move away from the silo-based operations within banks was the introduction of central counterparty services for swaps and repos, followed by equities from the derivatives clearing houses, such as LCH.Clearnet and Eurex Clearing. As other instruments, besides exchange-traded derivatives, became cleared products, the margining and netting requirements for these off-exchange products gradually came under the remit of derivatives managers, in that they were treated similarly to exchange-traded products within the bank.

Fabian Somerville-Cotton, who heads up the listed products and prime brokerage group for Dresdner Kleinwort Wasserstein (DrKW), says that all exchange-traded products, across equities, commodities and fixed income, come under one group at the investment bank. He believes there is value in the gradual decline of the silo mentality within the institutions. DrKW is very much taking a holistic approach to its customers, with one margin call across listed derivatives and across all listed products cleared through a central counterparty such as LCH.Clearnet.

Somerville-Cotton says:

> 'Desktop real-estate is so valuable these days that to run multiple platforms in order to access various exchanges and asset classes is unrealistic, so there is some natural consolidation from a technology perspective. But we are also being driven by the fact that customers are looking at the market with a much broader outlook and, as a result, are seeing a growing requirement for a 'one-stop' shop.'

FX trading has been added to the same platform to aid trading of listed stocks and derivatives and access to BrokerTec. The

bank's order routing platform, GATOR (Global Access To Order Routing), has been developed since 2000 and is now connected to 13 stock and derivatives exchanges, which, Somerville-Cotton says, covers, in volume terms, around 90 per cent of listed trading. Recently, the development, has moved away from pure connectivity to exchanges and more towards inclusion of other asset classes and improved trading functionality.

Says Somerville-Cotton:

> 'By having one gateway we can reach a broader customer base. Proprietary traders and hedge funds, dependent on the strategy they are following, are looking for volatility and liquidity in the market and if they see that on other exchanges they may not be as tied to the asset classes they traditionally trade, but more to the fact that a new market offers greater potential for returns.'

Similarly, Deutsche Bank underwent a restructuring last September, which saw all traded products — both exchange-traded and over-the-counter — come under one division, Global Markets. A spokesperson for the bank says that, while the different desks still operate separately, they work closely together, enabling hybrid strategies to be traded more easily.

To a certain extent, the different asset classes have always been closely linked, simply because of the correlation there will always be between derivatives and the underlying asset and due to the very nature of hedging — banks have always held cross-asset positions for hedging purposes. But some banks are taking this one massive step further in building transaction platforms that will perform the trade, the hedge and any related foreign exchange transactions in a single trade.

THE STEP BEYOND

Under the leadership of Kevin Bourne, Managing Director and Global Head of Execution Trading for Investment Banking, HSBC is radically overhauling its trading technology infrastructure to create a cross-asset-class messaging platform to support its electronic trading operations globally. The platform is expected to be complete by next summer. When complete, it will bring all cash, direct market access, algorithmic and programme trading flow into one system. This will give customers access to an algorithmic engine that will allow them do a foreign exchange, derivative and cash algorithmic trade simultaneously. Bourne says:

> 'The rational for building the platform is to enable derivatives and the underlying cash markets — equities, fixed income, FX, to be actually traded simultaneously. Initially demand was driven by the hedge fund industry but now these tools are required for portfolio management generally.'

According to a trader at a statistical arbitrage hedge fund, this move to cross-asset trading will eventually squeeze out the hedge funds seeking out anomalies while a large position is being rolled out and then hedged. He says:

> ‘Based on a simple correlation of asset returns you’ll find that many assets are related, especially when macro market stress occurs. The growth in cross-asset trading will definitely reduce the previous returns. I see a good five years still left in this strategy, however. Anomalies are due to the different modelling regimes of cross-asset trading participants — such as the different strategies of a hedge fund and an investment manager rolling out a large trade. More participants may decrease returns, but eventually it will cause the hedge funds to go model versus model. The best model wins.’

RUSH TO CATCH UP

This move towards cross-asset risk management has already affected the IT developers and software vendors, who are quickly bringing their equity and derivatives trading and risk management products together in order to provide banking customers with a single view of risk. While practitioners say that few vendors have the expertise needed across trading systems for all asset classes, so great is this trend that it is thought that there will be few specialist providers left in ten years’ time, as technology providers will have to provide systems to manage all types of risk.

Nigel Hartnell, Business Operations Director at derivatives application service provider (ASP) FFastFill, believes the derivatives independent software vendor (ISV)s have the edge here. He says:

> ‘The derivatives market stretches the requirements of the ISV in terms of performance and risk management, more than the equity players. The ISVs have already had to deal with the fact derivatives traders need to see the underlying markets, and some have already needed access to some form of simple trading in other markets.’

He adds that data is at the heart of this issue. Quite simply, he says: ‘If you can’t get your hands on all of the data, you cannot reduce operational risk and capital requirements.’ Hartnell believes financial institutions need to accept that they can no longer operate in silos and change their business processes accordingly. He says: ‘This may well result in a change to the role of the specialist business manager who may well find he has responsibility for reporting P&L positions across more than one asset class.’

Then, to ensure enterprise-wide risk management, all trades must be captured in one system, regardless of asset class. The most difficult step is to have some method of valuing these different trades across asset classes. Hartnell says:

> ‘There is a great need to avoid a situation where too much information is being given so that you cannot see the data needed. This is the challenge — to create a simple system for some very complex data, that is fast and does not impact the speed needed for trading. In our view, the architecture needed to achieve this must enable this to be done progressively. Our new generation technology enables capture of different

trades at the front end and then allows different risk management modules to be built at the back end.'

TREND SET TO CONTINUE

The goal is to centralise the delivery of trades for all asset classes through a single order management system (OMS) in order to enable a more holistic view of positions and pre-trade and post-trade risk management. There is already evidence that OMS providers are expanding the systems sold to investment firms to cover multiple asset classes, including fixed income, futures and options, and interest-rate swaps. A certain level of consolidation among vendors providing equity, fixed income and derivatives risk management software is inevitable. Currently, the derivatives ISVs are building cross-asset capability as the very nature of derivatives, spanning all underlying markets, gives them an edge for capturing less complex trades. Niche providers of FX trading and risk management systems, and those still specialising in equity or bond trading, could soon be left with the stark choice of merge or die, however. With so much investment already seen in this new direction, it seems that there is no going back and that cross-asset class trading, once the remit of the prime brokerage desks, will become part of an investment landscape which is built around how the asset manager trades, rather than how the banks are organised.