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How 'trading as a service' unlocks opportunities for banks

Scale is crucial for capital markets sell-side firms in flow businesses. Trading as a service can make scale benefits more widely available, with opportunities for large banks and other market players.

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For capital markets sell-side firms in flow businesses—cash equities and futures, foreign exchange (FX), cash rates, and cleared swaps—scale is critical. It directly drives productivity and profitability in those asset classes. Consequently, larger banks and other financial institutions are seeking to add scale, but most regional and national banks lack a route to achieve it.

A compelling way that both groups of institutions can meet their objectives is to offer or purchase “trading as a service.” In such arrangements, at-scale financial institutions offer subscale regional and national banks execution coupled with front-end and back-end services, while the smaller banks retain the last mile to the client.

To succeed, trading-as-a-service offerings need to provide a materially better end-client digital experience and an enhanced liquidity and product offering, as well as address enough areas of the cost base of a regional or national bank to deliver meaningful impact on their economics, including in the areas of risk, finance, operations, and technology. Organizations with the potential to build (or help build) such offerings include at-scale banks, a coalition of smaller banks banding together, nonbank market makers, and technology providers.

Many at-scale financial institutions are already endeavoring to provide trading as a service, but so far, their results have been mixed. To achieve greater success, these firms need a step change in go-to-market capabilities, including a platform-sales capability, C-level access, and dedicated investment to ensure solutions are multitenant ready and proven. Meanwhile, regional and national banks that contemplate using trading as a service should begin with a strategic review of future client needs, their ability to invest to compete on their own, and the implications of insourcing and outsourcing relationships on internal users of capital-markets services like their treasury units and retail and wealth franchises.

The problem of scale in capital markets

The structural importance of scale in capital markets flow products has put national and regional sell-side firms at a serious disadvantage, with challenged profitability. While these banks lack an easy route to achieve scale, larger institutions have every incentive to seek more flows to better monetize their existing platform and operations teams.

E-trading puts a premium on scale that few players can achieve

Scale is increasingly important in the markets in flow products (equities, futures, FX, government bonds, cleared interest-rate swaps) because electronification in these products has driven margins down. This forces banks to compensate with greater volumes to maintain and grow revenues. Electronification also forces banks to increase their spending on relevant technology, including connectivity to clients and venues, electronic market making and pricing, and automation on the back end to ensure that processes are “straight through” from trade capture to settlement.

This spending is better handled by large banks with sufficient revenues to justify and fund the necessary investment. Indeed, some of the largest banks have doubled down on technology investment in their electronic trading arms. This forces smaller banks to match their capabilities so they can maintain similarly competitive offerings, or else they start to lose share.

The situation gives a significant advantage to larger banks, as the business benefits of scale translate into major financial benefits. Scale is often correlated with greater productivity. Salespeople and traders at larger banks typically exhibit higher revenues per full-time equivalent because they benefit from better electronic platforms, tools, and information that allow them to process greater volumes and price more effectively. Scale is also correlated with lower cost per trade and greater efficiency (Exhibit 1).

Most regional banks have neither scale nor an easy route to achieve it

The problem, of course, is that in an industry with a history of flat revenue pools,[1] only three to five banks in a given asset class can be truly at scale. Many regional and national banks, for example, lack client bases of appropriate size and depth to have a credible route to achieve scale. This creates challenges in their capital-markets franchises.

On the one hand, capital-markets services are often an essential part of the regional and national banks’ broader product offering, and they serve as a critical way to monetize relationship lending. These banks also see these services as essential in maintaining their relevance to more sophisticated corporations and investors.

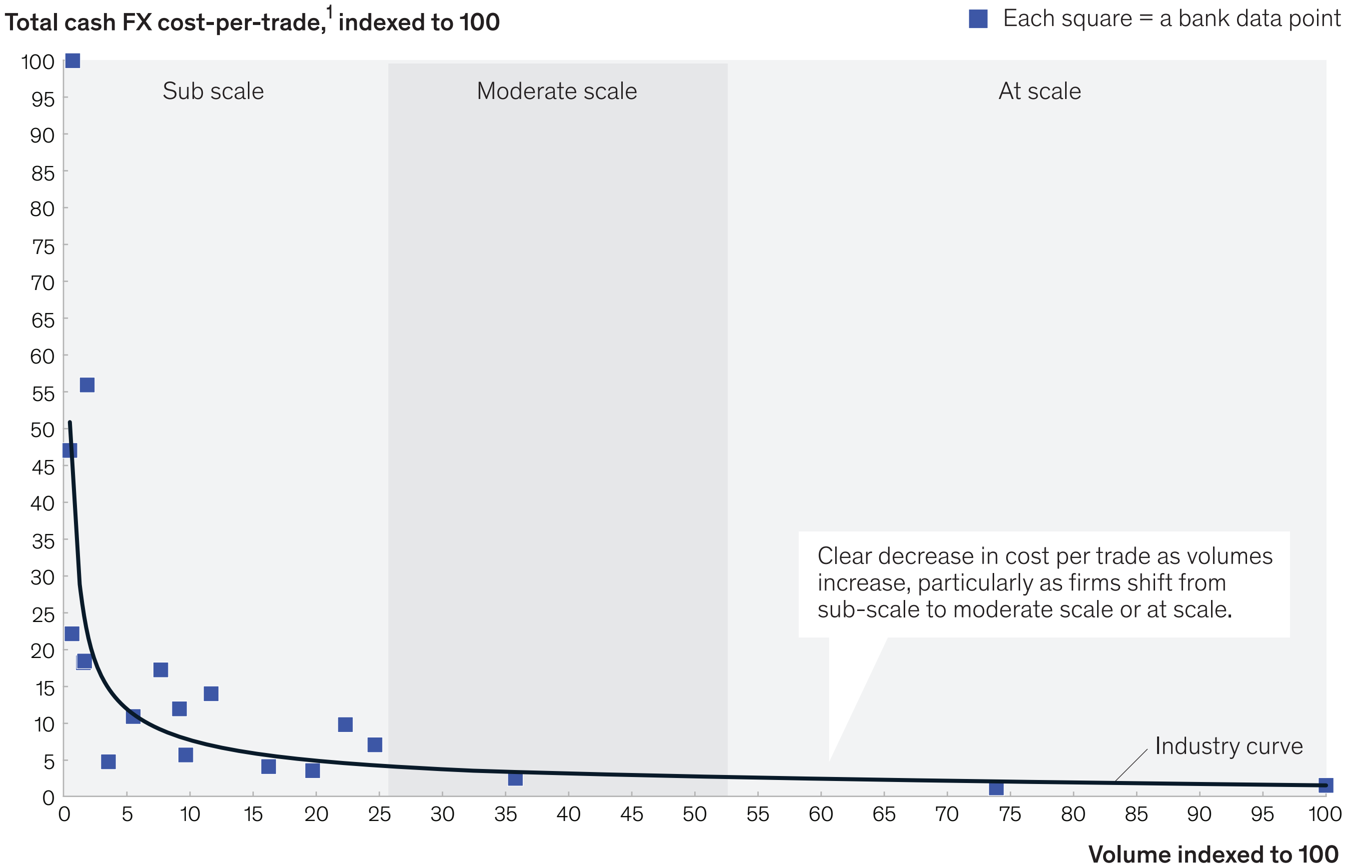
On the other hand, because they are smaller, regional and national banks cannot easily match larger banks’ level of technology investment in digital capabilities and channels, even as the larger banks compete to serve many of the same clients. Investment in strategic and business-enabling programs is further constrained by the “change the bank” spending these firms must direct to essential maintenance and regulatory initiatives such as the Fundamental Review of the Trading Book (FRTB) and trade surveillance. Finally, in certain products, including emerging-market currency pairs and rates options, regional and national banks may lack sufficient expertise and market presence to price competitively, and they risk adverse selection when

1 Volatility associated with COVID-19 caused a temporary uptick in revenues, but most firms expect this to revert to historical levels in the longer run.

Exhibit 1

Scale is correlated with cost per trade—FX example.

Cost per trade for representative banks



[1] Costs consist of back and middle office, IT run-the-bank, and IT change-the-bank.
Source: McKinsey Capital Markets Trade Processing Benchmarking Survey

they try. As a result, their franchises in flow products often suffer from lower profitability relative to larger banks, even though they feel compelled to retain these offerings.

Players at scale or nearly at scale need a way to add volume

While searching for scale is a poor strategic move for regional and national banks, larger banks that are at scale or nearly at scale have strong incentives to add flows to their platforms. These banks already have the electronic trading platforms and operations teams to handle additional volumes with limited increases in cost. Any additional revenues would increase their ability to fund differentiating investments in technology that widen the moats around their business. To the extent these revenues come from flows uncorrelated with market drivers (that is, linked to corporate payments or corporate hedging activity), they gain the additional benefit of diversifying the overall trading franchise.

‘Trading as a service’ solves the problem of scale

In a market environment where small banks lack scale and larger banks seek to add it, an attractive solution for both sides is the concept of trading as a service. In such an arrangement, larger banks insource the execution, operational, and technology components of flow trading from smaller banks while those smaller banks preserve the last mile to the client. In the past, institutions have tried more limited versions of these arrangements, but end-to-end services appear to have more potential for delivering better results in the current environment.

Previous attempts have been narrower in scope

Previous efforts at concepts similar to trading as a service have tended to be narrower in scope, offering more limited benefits.

— **White-labeling execution.** Partnerships have focused on white-labeling execution only. A larger firm acts as a liquidity provider to a smaller bank, reducing the latter’s role to that of an agent or a riskless principal. These partnerships, perhaps most common in FX, equities, and US treasuries, have definite value. They are used most frequently to help the smaller firm provide capabilities it could otherwise not offer—for example, in emerging-market currency pairs.

— **White-labeling front-end services.** In another type of partnership, the larger firm (or a technology provider) provides the smaller firm with front-end technology platforms and services. These can include a client portal or single dealer platform, order management and execution platforms, execution algos, or analytics including risk and valuation services. The primary benefit to the smaller firm is that it can defer or avoid the change-the-bank and run-the-bank technology spend associated with building, maintaining, and updating these platforms and capabilities.

— **White-labeling back-end services.** A third type of partnership involves the larger firm (or a technology provider) providing the smaller firm with back-end technology platforms and services. They typically focus on classic operations activities—clearing and settlement—and the associated technology infrastructure. The smaller firm can reduce or eliminate a portion of its own operations teams and systems in the areas covered by the service provider.

More benefits would flow from end-to-end trading as a service

While each of these solutions has had some traction, their impact has been limited because they apply to only a portion of the trade life cycle. Many don’t cover enough of the cost base of a typical regional or national capital-markets business to improve its economics materially. In other cases, solutions have covered very specific products (for example, certain currency pairs) but lack the breadth across products to allow the retirement of technology platforms that support a much broader range of products.

A far more compelling approach would be end-to-end solutions that combine execution with front-end and back-end services. These could deliver

Exhibit 2

An end-to-end "trading as a service" solution in FX could have a significant impact on economics.

Illustrative $200 million FX business, pre- and post-outsourcing, $ million

Component	Pre-outsourcing	Post-outsourcing, pre-profit share	Delta	Rationale
Revenues	200	210	+10	Increased revenues from more effective liquidity provision
Sales	30	22	-8	More e-sales driven model
Traders	30	7	-23	Reduced trading (trading largely outsourced to partner)
	141	181	+40	
Direct non compensation	43	39	-4	Reduced market data spending due to reduced trading footprint
	98	142	+44	
Operations	16	5	-11	Majority of ops outsourced to partner
Risk	10	8	-2	Reduction in market risk spending as bank is primarily agent
Tech	25	10	-15	Reduced spending on client portal, e-trading platform, ops tech, and other areas
Finance	8	7	-1	Less complex financial reporting needed
Legal and compliance	4	4	—	
HR	4	4	—	
Other	2	2	—	
Profit before tax	30	102	+72	Cost-driven benefits result in significant net income improvement

Source: McKinsey analysis

benefits across the value chain. Exhibit 2 gives an example of the potential impact of an end-to-end solution on a typical challenged FX business. The ability to broaden product capabilities, improve front-end digital capabilities, and reduce costs across sales, trading, market data, operations, risk, and technology can meaningfully increase the bottom line. The potential gains could be shared between the outsourcer and provider.

Opportunities are available to a variety of firms

While at-scale banks and broker-dealers are natural providers of trading as a service, a partnership of smaller firms (regional banks, nonbank market makers, custodians) can also build a credible offering. In addition, technology providers and private-equity firms can also play a role in building and scaling such ventures.

At-scale banks and broker-dealers. Banks and broker-dealers with large capital-markets franchises are a natural provider of trading as a service, as they have already built many of the requisite capabilities to meet their internal needs and the needs of their clients. Should they not wish to develop trading as a service completely organically, they could credibly partner with capital-markets technology providers and big-tech firms to fully build out the offering.

These banks and broker-dealers would reap additional benefits from providing an end-to-end offering to smaller firms. Most capital-markets firms rely heavily on either taking credit risk (via lending) or market risk (via trading). Offering solutions such as trading as a service alongside helps shift the business model to one that is more stable and platform driven. Further, offering such solutions gives banks an opportunity to generate revenues from capabilities in operations, risk, and finance, which have historically been cost centers. The banks would be monetizing their own infrastructure, in the same way multiple technology companies monetized their data and cloud infrastructure into full-blown client businesses. Finally, trading as service can be offered not just to smaller banks, but also to brokerage firms, wealth managers, and even relevant e-commerce players whose own clients have recurring trading or hedging needs. The revenue opportunity could be substantial.

Coalitions of smaller banks, nonbank market makers, custodians, and technology providers. Large capital-markets firms need not be the only type of provider. A coalition of two or three regional firms could pursue a similar approach, partnering with nonbank market makers and technology providers to fill out the offering. Some regional and national firms would prefer such a coalition, as it could be designed to include partners with complementary rather than overlapping client franchises and reduce the risk of potential disintermediation by a big bank or broker-dealer with more client overlap. Finally, a large custodian could easily replace the coalition of regional banks in this construct, provided it could build sufficient credibility around the execution layer, perhaps by working with a nonbank market maker.

Private-equity firms. Finally, private-equity firms have a role to play as well. Some have expressed interest in funding such ventures. The potential revenue streams are stable and very sticky because the services provided are essential. Once the firm has secured a few anchor clients, the investment profile becomes one with a safe bond-like return from these core clients, with substantial upside from adding clients on top of the initial participants.

Capturing the opportunity: Prerequisites and next steps

While trading as a service has great potential for banks and other sell-side firms, successful execution will require a focused set of partners willing to cocreate a scalable industry solution. In addition, appropriate ambition, sponsorship, and commitment of resources will further increase the likelihood of success.

Prerequisites for success

To succeed, partnerships offering trading as a service will need to possess the following key criteria:

- **Two or three 'anchor' banks to focus on first.** At least initially, solutions should be built around the requirements of two or three anchor banks that will use the service, rather than a much broader consortium. Focusing on only a few regional or national banks substantially reduces the initial complexity of negotiations and leads to a quick definition of a workable solution. The partnership can add more banks later, and present them with a mature off-the-shelf offering that is already proven, but without the option to fundamentally restructure the offering.

- **Flexible approach to solution design.** The initial approach to solution design should be very flexible. Trading-as-a-service providers and users alike should consider a broad scope of activities and structures. Many such discussions have been derailed by one party making strong assumptions about what services will or will not be in scope or insisting upfront that partners fit offerings to its own legacy systems in a way that hampers broader scalability.

- **Sponsorship at the top.** The partnership must be sponsored at a very senior level within each organization and be appropriately ambitious. The business case for trading-as-a-service partnerships is often most compelling at the division or bank level, where the challenges faced by the capital-markets franchise are clearest. The full economic benefits are realized only if the approach is extended across multiple asset classes and across the trade life cycle, and this falls outside the remit of individual product and functional leaders. Further, some product leaders tend to opt for incremental solutions or fear disruption to the status quo business, even if that status quo faces structural challenges. Senior sponsorship is necessary to push past such thinking.

- **Appropriate commitment.** All parties must commit appropriate resources. The process of negotiation and solution development with the anchor banks is time-consuming, and its success depends on appropriate resourcing, time, and managerial commitment. The effort cannot be part-time or a side project. Firms that are unwilling or unable to make this commitment typically see their efforts lose momentum, which damages their relationships and credibility with potential partners.

Mobilizing for action

Firms interested in this opportunity need to identify the immediate next steps. These vary according to the type of organization:

- Large banks and broker-dealers seeking to add scale should flesh out what a potential offering could look like and reach out to potential clients, quickly identifying two or three firms with which they can build a multitenant minimum viable product. Over time, as they seek to scale the offering, they will also need to invest in a platform sales capability, which is quite different from the skill set of a typical market salesperson or trader.

— Regional and national banks looking to outsource should pressure-test the internal business case for trading as a service, assess the implications of any decision on internal bank customers (that is, their treasury function and adjacent retail and wealth franchises), create a short list of potential partners, and reach out to a subset with their proposed solution.

— Nonbanks, technology providers, and other potential entrants should consider what set of capabilities is required to build a compelling offering and where they can find potential partners to fill in any gaps in their own capabilities. They should then follow a similar playbook to that of the large banks: identifying and reaching out to two or three firms and ensuring the right platform sales capabilities are in place.

The time to move is now. The structural challenges that subscale regional and national banks face in capital markets will persist. Many of these firms will need to continue dealing with clients who require increasingly sophisticated electronic trading and digital capabilities but lack the investment capacity to make these investments. In so doing, they will be forced to contend with challenged return and cost profiles. Conversely, for at-scale banks, selected nonbank market makers, custodians, technology providers, and private-equity firms, the commercial opportunity is new and compelling.

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