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Banknote and Precious Metal Trading – The Case For Automation

Greater regulation | More complex compliance | Fierce market competition





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ABSTRACT

Many banknote and precious metals businesses have already adopted an automated approach to managing operations. Indeed, such is the proliferation of automation in this sector today that any operator who has not yet switched to the rapid, accurate and efficient facilities of systems-based transaction and management could now be said to be at a serious competitive disadvantage.

This paper explores the compelling reasons why a growing number of successful dealing businesses have embraced the advantages of automation. It sets out the principles of systems based transaction and management in terms of how these address the whole spectrum of business needs and governance, as well as the mounting demands of regulation and compliance in an increasingly complex sector.



THE EMERGING BUSINESS CLIMATE

All banknote and precious metals trading businesses face emerging challenges and inherent risks. These range from foreign exchange (FX) to credit risk, operation and dealing control, sound governance and solid audit measures - all of which must be managed in order to create and sustain a profitable business.

An essential tool in maintaining competitive advantage in today's global economic and regulatory climate is a robust automated solution that specifically addresses this intricate matrix of needs.

It is certainly true that non-automated organisations find up-scaling more arduous to manage. As business expands and additional traders and cash room personnel are drafted in, it becomes increasingly difficult to track inventory manually as more people are buying and selling concurrently.

Compliance with anti-money laundering regulations is another area where the automated business has the advantage. Good record keeping is key here, but paper-based systems are confoundingly labour intensive when there's a need to locate specific compliance data. And of course the manual method lacks the flexibility to view data in a variety of contexts - for example: all transactions per customer larger than a particular size; or locating missing stock when the inventory fails to balance.

THE NEEDS OF THE BUSINESS

Real-time Position Monitoring

Any organisation that deals in banknote and precious metals trading needs up-to-the-minute logging of positions for foreign exchange risk management. FX and commodity risk is a by-product of dealing in banknotes and precious metals at the wholesale level, so dealers have to be skilled in servicing the core business of banknote distribution as well as being FX dealers to manage risk and even create



profit from FX and gold.

The unique aspect of wholesale banknote dealing is the positions created from the physical FX and precious metals that need to be managed by pure FX deals.

Automated trading provides the tools with which to monitor and manage FX positions created from dealing on the physical side, as well as the investment banking transactions which can also be entered into the system. Ongoing revaluation of stock in hand against prevailing market rate becomes a simple matter, providing a clear picture of profit and loss and aiding decisions about how much risk to offset with hedge trades.

Stock Control

In today's ultra-competitive world, customers have an increasingly keen awareness of their power to demand service quality. Indeed, customer service has become one of the driving motivators for all market-facing business. For dealers in particular, effective customer service requires knowledge and availability - knowing your stock inventory down to the denomination and quality level; knowing what stock is coming, and from which customer, as well as what is on the way out. An automated system offers powerful tools to provide the dealer with real-time information about the current stock, as well as vault activity. Accurate management of stock levels gives the dealer the confidence of knowing at transaction time what can be offered to the client.

Efficiency of inventory management also prevents a situation in which two dealers might attempt to order the same stock, both believing they are short of inventory. Each dealer will have access to real-time information on what stock is currently in-transit between locations and what is on-hand in the vault and available to sell.

Further, because both trading and cash-room tracking is combined within the same system, there are no double-handling problems of time lapse between what stock

is available and what is being traded.

Cost Control

There are more substantial and complicated costs involved in banknote and precious metals trading than in any other financial product.

There are the logistics costs of shipping - security vehicles, airfreight, courier transport, per-kilo weight of shipment, insurance and so on. And there are financial costs, including overheads associated with vault operation and fees for making settlement payments, as well as the funding of settlements and overnight positions.

As a manual process, such calculations are time-consuming and prone to error when carried out under pressure. An automated system, on the other hand, manages the complete matrix of logistical costs. The dealer has instant cost analysis to hand at the time of the deal, showing what the costs would be. Better still, he or she can explore alternatives in order to maximise profitability. For example, the dealer might offer to pay the client's insurance premium in return for an advantageous exchange rate.

At the same time, the automated system will be managing the FX funding requirements for settlements and positions. It will also support decision making in consideration of opportunity cost of holding of an inventory of banknotes.

Profit and Loss

The ability to track profit and its sources is a key requirement for even the simplest of businesses. In an operation as complex and variable as banknote and precious metals trading, such information remains just as vital - but exceptionally difficult to monitor and assimilate.

As exchange rates fluctuate, the value of inventory held will change, sometimes as



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rapidly as hour by hour. Most dealing businesses will want to revalue their inventories at least once a day - some more frequently - in order to track unrealised or revaluation profit/loss.

They also have to know precisely the realised profit or loss made on actual turnover - the value of sales against the cost of the inventory that has been sold.

Such intricate arithmetic is a slow and laborious manual exercise. It is no wonder that trading businesses are so anxious to automate the process. Not only will the system accurately measure realised profit/loss from trading and as revaluation profit/loss; it will analyse the data in a variety of ways - by currency, by dealer, by client or by groups of clients.

Here, surely, is one of the most critical areas in which the sheer speed and facility of an automated system sets a trading business ahead of its non-automated competitors.

Integration and Straight-through Processing

Integration of front and back office operations is essential for any financially based business. Without the benefits that accrue from straight-through processing, real-time information and ease of management, the competitive edge will certainly be compromised.

An integrated system not only merges front and back office data; it also simplifies the interfacing requirement into general ledger systems, payment systems such as SWIFT and other banking systems such as credit control, as well as anti-money laundering software.

In addition to the integration requirements of the back-end operation, for many trading businesses it's also important to be able to input data into the wholesale system - for example, orders captured from other systems - or to manage positions of a retail trading system.



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Integration of the cash room or vault processing function enables the cash room staff to count money in and out, based on the orders placed, and allows the dealer to see cash on-hand as soon as it has been received. Such clarity also allows the organisation to set the policy on what would best be done with discrepancies such as shortages and overages - for example, to automatically sell a shortage back to the counter party, or hold it in a pending status. Meanwhile, the back office has instant knowledge as soon as the cash has been received and can confidently settle the deal.

Automation also implies integration with external logistics systems. Transit companies appointed to ship a consignment can thus be passed secure shipping information to enhance speed and accuracy of delivery.

GOVERNANCE

Audit Compliance

Audit compliance has become the single biggest hurdle in setting up a banknote and precious metals trading operation. In addition to the logging of information on all critical internal operations, there is the need to export data to anti-money laundering systems, to track changes made to orders after they have been placed and monitor changes to user information.

Certainly, any non-automated trading business will be finding it increasingly difficult to satisfy the growing demands of regulation. Verifiable data is required to confirm the legal compliance of the institution - audit trails at every level of operation, covering everything from reference data integrity to logging user activity that occurs on a deal.

Trading Controls

Recent times have seen some shocking revelations about the ease with which

rogue traders have been able to bring large institutions to their knees due to lack of control.

A key feature of automation across the financial sector is inherent control of individual activity - but with the appropriate level of customisable control. It's important to define who should have access to which system functions in the organisation. Which deals will be sanctioned to go straight through and which must be put on a release queue for authorisation. The 'four eyes' principle of dual control provides that extra level of authorisation that helps protect the business from the risk of rogue trading.

It follows that a practical automated solution for banknote and precious metals dealing will deliver comprehensive facilities for system control - for example: controlling dealer trading limits, the ability to adjust deal rates relative to the prevailing market rates, cancellations/corrections of completed deals, managing credit risk of counterparties, managing the organisations' foreign exchange exposure by tracking positions against preset limits or changes to the standing settlement instructions of a counterparty.

Credit Risk

Banks and financial institutions must also deal with risks outside their own organisations. Having creditworthy clients is a challenge in itself, and management of these is crucial to a successful operation.

It is as important to the business to track clients in terms of how much they owe at any point, as it is to track exposure to the general market and the revaluation profit/loss potential of market movements, up or down.

Automation offers many levels of credit and exposure risk management, as well as the ability to feed credit information into the organisation's risk management system. A good system will track credit risk at the counterparty level, single deal



level and volume spot level. It will also manage deals where there is no risk because the client fulfils his obligation first.

COMPLIANCE

The world's governments are imposing increasing regulatory control on financial service providers, and on foreign exchange and precious metals traders in particular. Their intention is to curb the activities of criminals who have shown a keen predilection for exploiting these products for such purposes as money laundering and funding terrorist activities. The foreign exchange industry is considered to be at a particularly high risk of exploitation.

This area is perhaps where automated systems become a must-have, rather than merely a would-like, for traders of banknotes and precious metals. The fact is that it would be formidably expensive to establish and sustain compliance with the draconian provisions of anti-money laundering legislation internationally.

In order to keep the cost of providing this information to the regulator to a bare minimum, quite simply the business needs automation.

The system must be capable of implementing dealing controls, segregating duties between front and back office, and producing reports and files that can be used for the purpose of compliance. In addition to having its own reporting capability, it must be able to export data to third party anti-money laundering systems and, ideally, comprehensive management of customer information to satisfy 'know-your customer' precepts.

Some of the fundamental requirements of compliance are being able to identify large transactions, repeat transactions in a certain time frame (also known as velocity checking), and the ability to demonstrate good record keeping.

Automation also enables customers to import detailed AML data from the trader's system. While the dealer's automated system is not an AML facility in its own right,



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it does provide all the raw capability to capture and report on all activity within the system. This provides a verifiable audit trail that can track any changes made to a transaction throughout its life within the system and assist the organization with meeting its compliance obligations.

CONCLUSION

The case for automation is compelling indeed. Certainly any dealing business that implements such a system will very soon be wondering how they ever managed without it.

More significantly still, today's prevalence of automated processing in the banknote and precious metal trading sector must surely make the adoption of a systems based approach a priority for businesses that have not yet taken this step.

Automation provides knowledge and, as Sir Francis Bacon remarked as long ago as the sixteenth century, 'knowledge is power'.

About IMX

IMX Software is the global leader in banknote trading and travel money technology solutions. Founded in 1991 and headquartered in London, the company specialises in developing software solutions for three market segments: wholesale currency and banknote trading; currency distribution and fulfilment; and retail foreign exchange and travel money products for business-to-business.

IMX wholesale and distribution solutions automate the processes that support the purchase, sale, fulfilment, secure shipment and settlement of high volume bank note, foreign currency and precious metal trading with integrated reporting tools that support internal audit and compliance obligations to the high standards demanded by central banks. IMX retail solutions automate the provision of travel money products and cash, and foreign currency exchange via point-of-sale and e-commerce channels, with full support for international anti-money laundering regulations governing such transactions.

Over 100 organisations across the globe have benefited from IMX's solutions, including American Express, HSBC, M&S Money, ANZ Bank, Credit Suisse, Commerzbank, Royal Bank of Scotland, Travelex and the UK and Australian Post Offices.



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