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Transforming the markets middle office

Catalysts, challenges, way forward

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A chequered ride

Capital Markets have experienced significant evolution in recent times. Advancements in technology, increased regulatory demands, transition to more complex trading products, newer asset classes and geographies have all contributed to this overhaul. While the front office has traditionally been in the spotlight and received much of the budget and resources, the markets middle office, which is the lynchpin in post-trade operations has not got the attention it deserves.

The middle office has largely experienced disorganised expansion stemming from business growth and regulatory burden. Its multiple siloed systems and redundant processes, requiring a large workforce, have led to cost pressures, and shrinking profits.

In the current high-cost, low-margin environment, a leaner middle office is imperative for a competitive edge and to support the increasing demands of today's business landscape.

CRISIL is releasing a series of publications covering the transformation journeys of firms in this space, including resolution of day-to-day challenges, latest regulation that is driving the transformation, and implementation of additional controls. In the anchor paper of this series, we discuss the catalysts, challenges and way forward for middle-office transformation.

Firms have begun questioning their middle-office practices, aiming to make them future-proof. This section covers CRISIL's observation on the drivers of middle-office transformation.

Reduce cost and boost margins

Amid rising cost of doing business, stringent collateral requirements, and fee and margin compressions, a transformed middle office is widely accepted to be a differentiator for firms.

A middle office without redundant processes, numerous legacy systems, and vast resources for exception handling will stay ahead of the curve in today's market conditions. It allows a firm to think strategically and explore new business prospects.

Support front-office electronification

Rapid electronification of trading has been observed not only across the equities, fixed income, and forex asset classes but also in alternative investment products.

Electronification of the front office needs to be well-supported by middle-office functions that follow straight-through processing (STP). For the front office, STP allows a real-time view of the portfolio's current exposure and understanding of risk parameters and margin requirements, among others.

For example, automated failed trade processing and notification can avoid limit breaches at the front office and provide a better view of cash and capital requirements.

However, in many firms, this process is still manual and via email. Though there is intraday availability of data, real-time data is not easily available. This inefficient flow of data affects the settlement cycle as well. Hence, there is great incentive for firms to revisit their middle-office processes and convert them to STP to the extent possible.

Streamline regulatory compliance

Middle-office functions had to shoulder much of the regulatory burden after the global financial crisis — be it the European Market Infrastructure Regulation (EMIR) reporting requirements, Markets in Financial Instruments Directive (MiFID), uncleared margin requirements, recently implemented T+1 settlement cycle, or upcoming Securities and Exchange Commission (SEC) final rule on central clearing of eligible treasury securities and cash transactions.

Firms have largely addressed the tight regulatory timelines by establishing siloed processes and adding in-house and vendor solutions to the long list of existing legacy systems. However, as regulatory requirements continue to evolve, firms have recognised that effective compliance needs unified processes and efficient record-keeping and reporting.

They realise that regulatory compliance will be less painful if they harness synergies across various regulatory requirements and lean on the operating model set up in one region for regulatory compliance in other regions.

This has prompted firms to revisit their middle-office processes and workflows.

Challenges

Middle-office transformation can be a complex endeavour, leading to additional cost pressures if the execution is flawed. Firms are constrained by less-than-ideal technology architecture and operations. This section examines the common transformation hurdles.

Multiple siloed systems

The rapid expansion of firms in the past 20 years has led to the creation of parallel technology stacks and numerous tactical solutions with no vision towards a consolidated IT framework.

Firms are now largely organised by lines of business, asset classes or geographies, having few common systems across them. Very few multi-asset platforms in the market can provide support across asset classes.

To transform the middle office, firms must navigate these highly segregated architectures, which have minimal interoperability among them.

Inconsistent flow of data

The segregation of systems has led to the absence of a golden data source, thus requiring the middle office to access and reconcile data from multiple sources.

Batch processing of data, which is the general practice, results in inconsistent data between the front office and downstream process, especially in case of batch delays.

Region-specific data feeds following different snap times to capture end-of-day data also lead to use of inconsistent market data. Inefficient flow of data further hinders a firm’s transformation journey.

Overlapping operational processes

A web of operational processes has been set in motion to compensate for the lack of system interoperability, as firms look to grow business and meet regulatory requirements. These processes are not scalable and often serve to address specific problems.

Post-trade reconciliation or confirmation are examples of processes that are extremely manual, thus straining the entire trade operations value chain.

Siloed systems and poor data flow prevent firms from capitalising on the STP options available for these processes. The inefficient flow of data has compelled firms to set up overlapping processes to reconcile positions, cash, net present value and reference data.

Use of legacy technology

The use of legacy technology further restricts the data flow. Most of the post-trade operations are still captured on Excel.

Emails and voice messages remain the most common forms of communication both within the firm and outside (with counterparties).

Though there are industry-wide utility tools to match trades or share daily collateral and settlement data, exception handling and dispute resolution still require manual intervention with multiple steps.

To truly transform the middle office, the industry must shift from legacy technology toward a more standardised approach to operations. That said, this industry-wide overhaul will not be easy.

Way forward: The pillars of transformation

There is no one-size-fits-all solution to achieve a leaner and efficient middle office.

Our experience suggests that large overhauls impacting numerous processes simultaneously are more suited to the larger firms. Tier 2 and 3 firms should follow a segmented or phased approach, starting with the resolution of the biggest problems at hand and then working their way downwards.

Either way, a transformation programme would aim to achieve one of the pillars of transformation: i) ***consolidation*** of disparate systems, data sources, and redundant processes, ii) ***increased controls*** to enable availability of reliable position, exposure, cash, and risk data for fast-track decision-making, and iii) ***regulatory compliance.***

In the upcoming papers, we will focus on the ongoing transformation of some of the highly complex functions of the middle office to achieve one or more pillars.

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