The Business Case for Overhauling the Back Office

There is little doubt regarding the extent to which the financial services industry has been shaped by regulation in the wake of the global financial crisis more than a decade ago. And while those amendments have largely been successful, they have focused mostly on the front office, leaving back-office processes well overdue for extensive overhauls.

In the wake of the global financial crisis, regulators and lawmakers on both sides of the Atlantic scrambled to rewrite the industry's rulebooks to ensure that it wouldn't happen again. The two most significant pieces of regulation emanating from the crisis—the Dodd–Frank Act in the US and the revised Markets in Financial Instruments Directive (Mifid II) in Europe—required market participants to firm up their operational frameworks, while regulators took a more hands-on approach to monitoring those entities under their purview.

Substantive Additions

While the new regulatory regime introduced new capital adequacy rules, greater emphasis on credit and counterparty risk, improved disclosure and transparency, and investor protection, they largely ignored back-office processes, which for large numbers of entities remained manually intensive. "From an operations perspective, the investments that were made to meet all the regulations and those still coming down the pipe like the Securities Financing Transactions Regulation (SFTR) have meant that firms have focused their resources on getting their data from their trading and back-office systems to the regulators," explains Chris Smith, head of post trade at MarketAxess in London. "The implication is that all of the investment that was available to them just went into that—ensuring that the data could get to the regulators so that they could do their jobs more effectively and police the markets better than they did prior to the global financial crisis."

Years of Neglect

Smith argues that the primary role of the back office—ensuring that transactions settle successfully on their due date—has been neglected to the point where back-office functions are largely identical to what they were more than a decade ago. "Moving information from firms to regulators has diverted not just investment but, importantly, creativity away from making our markets more efficient while reducing costs and risk," he explains. "It might have helped regulators police the markets better—and that's a good thing—but settling trades and ensuring that they do not fail hasn't improved in decades."

There needs to be greater industry acknowledgment regarding current back-office deficiencies, particularly while the specter of the upcoming Central Securities Depositories Regulation (CSDR) looms large across the European marketplace, which the European Central Securities Depositories Association says is likely to result in fines and associated costs of €2.2billion a year. Clearly, it is in the interest of all industry participants to ensure that their back offices are operationally and technologically optimized. It is critical, however, that this optimization drive includes the industry's broader operational framework.

The Way Forward

The global fixed-income market is larger and more complex than its equities cousin. It has, therefore, taken longer for it to evolve by way of new tools, technologies and electronification, directly impinging essential post-trade processes, including matching, reconciliations, exceptions management and reporting. Given the intricacies of the bulk of fixed-income instruments, this challenge is by no means trivial, although making the business case for deploying the technologies to automate these functions has never been more critical. And, while the trading of the bulk of fixed-income instruments is still transacted over the counter, as the market moves to become more electronic, firms like MarketAxess have already implemented technology frameworks that have appreciably enhanced the efficiency with which they are processed.

"Trading on MarketAxess means that, in theory, further down the post-trade stack you have more efficiency, because when two counterparties enter into a trade, there is agreement about the International Securities Identification Number, the type of bond they're trading, the coupon rate, the settlement date, and the venue where the trade will be settled," Smith explains. "But all those details still need to be agreed and MarketAxess helps with that.

So you not only execute the trade on MarketAxess, but the post-trade world of MarketAxess helps with all the follow-up information, which means that a trade executed on MarketAxess can be matched with all that post-trade information within a few seconds. That means fewer exceptions, fewer failures, faster operations and, ultimately, less operating cost."

Clearly, technology holds the key to satisfactorily addressing the bulk of the industry's operational pain points. And, while embracing such technologies has an associated cost, the business and operational costs of ignoring the problem are appreciably higher. wt