The new normal

Gregory McDonald and Nick Clarke of GBST Capital Markets explore the changing face of operations in an increasingly risk-focused marketplace

Understanding risk, as any financial firm will tell you, is all about transparency. From market risk to credit or operational risk, a firm needs to have an enterprise-wide view of their precise exposures at any given moment.

Transparency is based not only on the amount and quality of information a firm has but also on its timeliness. Trading firms can't wait until their end-of-day batch processes have finished to gain a proper view of their risk profiles. They need high-quality risk-related information in real time.

The regulatory pressure to achieve transparency is also being very clearly felt. In an effort to reduce systemic risk at every level, regulators around the world have implemented a series of measures to encourage better risk management practices by trading firms, investors, brokers and trading venues.

Take, for instance, the regulatory emphasis on more exchange-like trading for over-the-counter instruments, as seen in the European Market Infrastructure Regulation and US Dodd-Frank Act rules. Or the implementation of CASS rules to segregate client money, the transition in the US to T+2, or even the so-called Volcker Rule that aims to prohibit banking firms from engaging in certain proprietary trading. These are all examples where a desire for greater transparency in a more timely fashion is changing the way trading firms do business.

However, pre-trade risk controls in many cases rely on post-trade information, so the more that middle- and back-office functions are able to speed up their processes, the greater the firm's ability to gain transparency and, by extension, manage and mitigate risks. That trend has resulted in a much greater emphasis on cutting-edge technology within middle- and back-office functions.

The best mechanism for achieving transparency is fast forwarding what happens within operations, and processing transactions after they occur much more quickly.

Embedded risk

One issue that faster post-trade processes can help firms grapple with is embedded risk. This occurs when a broker-dealer executes a trade for a particular party, and that client in turn is buying or selling on behalf of other parties, each of whom may have a different risk profile.

The broker-dealer will therefore not be aware, intra-day, of what kind of embedded risks it is taking on. However, GBST, through its Syn~ family of products, allows users to form this consolidated view of a firm's overall trading positions in real time.

While regulatory change can be time-consuming and resource-intensive for many firms, there also may be an upside to the process. As regulators aim to mitigate credit exposures between broker-dealers and clients, the result is better client service. On balance, what's happening is they are forcing more rapid communication between brokers and clients.

Multi-jurisdictional

Where the idea of gaining real-time transparency gets tricky, however, is when trading starts to take place in multiple locations, each of which may have different regulatory regimes.

GBST is looking to provide a consolidation mechanism to firms with global positions, as well as the settlement status of those positions from different regions. There might be many underlying systems in use in different regions, and that may be because there is local connectivity into the market infrastructure.

In other words, a broker-dealer transacting with a global fund may be taking on embedded risk with clients from all over the world at any given time. For instance, a market may be settling in a distant part of the globe and that means securities may need to be borrowed to meet a position. A system that can escalate those and other kinds of risk-related issues to regional, global and functional operations managers becomes vital, ensuring that all the right people can see the information they need to in a timely fashion.

The regulatory focus on transparency shows no sign of abating, and that leads to operations managers thinking about risk differently. From a practical perspective, the operations managers are now the ones who, in a lot of ways, are managing some of the key risks for the firm.

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For those risks to be managed effectively, transparency needs to become more than just a goal; it needs to be automated and built into a firm's workflow.

Systems need to be able to escalate issues or risks on a global basis to an operations manager, and then apply rules to aspects of the operation. That could mean the ability to apply limits or authorisation points on the fly. Or, if there's a regulatory change, it could mean altering the system to capture new types of trades within a post-trade process.

Systems also need to be flexible enough to accommodate manual intervention. Rules should be put in place within the workflow that help mitigate operational risk, 'fat finger' risk, or the risk somebody will push through a transaction that maybe shouldn't happen, for example, maker-checker controls.

Operations managers have long focused on technology as a means of gaining efficiency or putting in place more robust processes. But with this new emphasis on risk, they are increasingly looking at technology in terms of the transparency it can bring to the operation.

The trend is one-directional and in a lot of ways, it's the new normal from an operations perspective.

Whether this increased focus on real-time risk information is a result of regulatory pressure, competitive dynamics or the operational benefits that technological progress can bring, it means that operations managers now face a very different world compared to only a few years ago. It's a world that creates both challenges and business opportunities as financial firms look to gain real-time insight into their trading positions. In other words, meeting those challenges and seizing those opportunities is what the 'new normal' is all about. **AST**

Nick Clarke
Head of capital market solutions
GBST Capital Markets

Gregory McDonald
Head of product strategy, North America
GBST Capital Markets