Derivatives Post-Trade Processing – The Future is Now

Firms operating in the listed derivatives markets are faced with a series of factors that are increasing the urgency to modernise their post-trade operations and technology:

- **Shifting growth dynamics:** Underlying volume growth continues, but is based on changing patterns at both a regional and product level – witness the current upward trending in Latam and Asia regional volumes, or the general slowing of commodity ETDs. Participants need the flexible capacity and operational agility to react quickly and efficiently.

- **Regulatory change remains a budget priority:** Regulations have forced participants to divert their limited “change budgets” to support mandatory compliance instead of much-needed and overdue technology improvements. Many firms’ cost/income ratios remain a barrier to breaking this cycle.

- **Exposure to operational risk:** Hampered by legacy technology, FCMs/GCMs are limited in their ability to advance their business without incurring operational risk, due to challenges relating to scalability, workflow complexity and inefficient operational process control frameworks.

A tipping point has been reached where the traditional ‘back-office’ in cleared derivatives needs to be reimagined in order to remain fit for purpose. This may seem somewhat self-serving but the case for wholesale structural change in the way cleared derivatives are handled throughout their lifecycle, in order to remain viable as a business line, has already been made – we now have to see the delivery.
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The catalyst for further efficiency is that operating a profitable global derivatives client clearing operation is increasingly difficult with the tools, systems and strategies that have been the mainstay for decades. Slow reaction times from incumbent providers, high capital costs, under-use of captive data and rising technology spend have forced those firms who wish to maintain a viable client clearing operation to reassess everything that they do and deliver a step-change of efficiency levels across the board. Nowhere is this more apparent than in the cleared derivatives post-trade arena.

New technology and an openness of approach from market users now offer the opportunity for firms to advance beyond their current over-reliance on legacy platforms, with FCM/GCMs seeking to redefine their business for the changes to come.

FIVE KEY OPPORTUNITIES IN PURSUIT OF CHANGE

Let’s take a look at five of the key areas that operations teams, post-trade providers and other stakeholders in the trade lifecycle will need to consider as they look to transform.

1. Multi-asset post-trade processing – the drive for efficiency

Without doubt, the biggest change (and challenge) to the processing of trades that is happening today is the move to establishing streamlined cross-asset operational teams and technology to process trades throughout their lifecycles.

The individual silos in which post-trade processing has traditionally taken place are being questioned by firms as they recognise that many of the same functions are performed within each platform. The current approach adds significantly to the human and technology resources required to undertake processing whereas a multi-asset strategy enables post-trade risk to be monitored from a single point, leading to greater oversight and control over the business and more timely action to mitigate the risks in question.

The implication of such streamlining is obvious at a cost level. The potential for more efficient deployment of resource and systems throughout an organisation simply by recognising the non-unique nature of certain activities is huge.

Additional benefits lie in a closer understanding of assets and liabilities throughout their lifecycles leading to the potential for more efficient use of assets and greater value creation as a result.

There is also a significant reduction in operational risk by adopting a multi-asset approach. Streamlined straight-through processing and centralised exception management can reduce trade breaks and mitigate operational risk. Real-time reconciliation is also more easily facilitated.

In addition, the cost of compliance with regulation and implementation of solutions is mutualised across asset classes, providing economies of scale versus the relatively costly and cumbersome approach across legacy silo systems. This is possible because underlying the multi-asset class processing model is a unified approach to data collection and management which enables an enterprise “golden copy” of all trade and post-trade-related data.

There should be no illusions about this process – it can be complex and there are risks - however, any new entrant challengers are unlikely to accept the status quo as a starting point (they have not done so in retail banking so why should wholesale capital markets be any different). They will find ways to homogenise the capture and processing of trade and transaction data and in doing so will be well positioned to drive a new wave of change.

2. Data – unlocking the potential at the core of the enterprise

A clean and mutually-agreed data set at the heart of the market is essential for risk management and record keeping. However, the listed and OTC cleared derivatives markets have relied on the fact that trades are held within clearing functions, which in turn act as the source record for managing data within legacy systems. This overly relies on the reconciliation process to ensure that details are correct and in alignment, but in doing that externally it often fails to fully utilise the data in a way that reduces operational risk.

By adopting a centralised data model, firms can more easily enrich enterprise systems and services for the benefit of operations and business management and, ultimately, end-clients. Conversely, an over-dependence on clearing records discourages change within the core systems architecture (so often cited as ‘too risky/expensive to change’), and means that for every additional data use, a bespoke solution has to be built which leads to inefficiency and unnecessarily high cost every time changes have to be made.

Regulatory reporting would also benefit from a strategic, centralised data model – rather than pull data from specific systems for specific reporting instances, the centralised data
pool would allow for a unified approach to reporting and interfacing with external systems. It also provides the opportunity to significantly improve analysis, data mining and business optimisation.

3. Static data – an ongoing conundrum
It is fair to say that a lot has been done to improve the quality of static data available to the market from third party suppliers; however, firms that still rely on elements of their own input of static data continue to experience significant challenges.

Recent regulatory changes such as MiFID II have enforced (in some cases) the introduction and extended use of international standards for data in the securities world and listed derivatives will be included after a granted extension (BaFin extended for Eurex, FCA extended for ICE and LME) to July 2020. Examples of this specifically include the reporting of MIC identifiers for Exchanges/Venues (ISO 10383), the ‘intended mandatory’ use of Legal Entity Identifiers (LEI) for trading parties/participants (ISO 17442) and a move towards consistent and uniform identification of instrument/contract data via the use of ISIN (ISO 6166).

The quality of static data is crucial for so many market participants, and advances in technology use within participant firms will be seriously hampered if static data is not cleaned up properly. Firms that optimise their static data will be in a strong position to manage market risks and as a result explore and enter new products and services in a way that is complementary to their existing business. After all, firms reconcile trade and post-trade data in excruciating detail on a daily basis but rarely, if ever, undertake the same process for the data that underlies their entire operation.

4. Collateral management – the drive for optimisation
The focus on collateral has grown in recent years to the point where it is becoming a tradable product as much as an enabler for transaction funding. Firms are no longer content to lodge collateral and leave it in one location but are optimising their own and their clients’ collateral in listed and OTC derivatives as they seek to assess which assets are best value.

In line with this, many firms are now looking at on-boarding sophisticated collateral management systems. They are also looking at managing and optimising collateral across asset classes in the same way as for post-trade processing. It makes considerable financial sense to understand what collateral is available and where and how that might best be deployed against obligations in an industry where margins are under extreme pressure.

5. Time to market - closing the gap
In a world where transactions are completed in fractions of a second and risk is assessed in real time, it is no longer acceptable for a clearing broker servicing clients to endure an excessive delay for a technology provider to deliver a new module for access to a new product or market – or even to make adjustments to an existing product. For many firms that undertake client clearing, the frustration with legacy derivatives post-trade technology and the inability to keep pace with market innovation is becoming an increasing problem.

The underlying issue is that these legacy systems are based on old, inflexible and often complex technology that is not able to react to the immediacy of markets. Such limitations impact the delivery time and cost of updates, and users within a vendor community could be forgiven for wanting to be first in line if they sense a queue, and assurances that innovation priorities are suitably aligned to their own success drivers.

One could understand the lack of speed to market for new contracts that were being supported if they were significantly different from others already in existence, but these are standardised derivatives. Fortunately, the ability to set up newly listed products without delay exists in the new generation of post-trade platforms; conversely firms sticking with legacy technology may begin to experience the cost of delay in terms of both client retention and support expenses.

We are increasingly likely to see market innovations going live much quicker than ever before. The catalyst of bitcoin and the interest in DLT-based solutions for market access and support, combined with the increased pace of FinTech innovation, will inevitably lead to a significant decrease in time to market for new products and services. The requirement for post-trade service providers to keep pace will increase rapidly as a result.
CONCLUSION
Some of these issues have been known for a number of years, some of them are building as a result of regulatory change, technology innovation, and the pressures on operational costs that all market participants face.

Whatever the reasons behind them, these (and other) issues will be central to the next wave of innovation and cost reduction for exchange traded and cleared derivatives. Market participants want efficiency, FCMs have to provide it or lose out in the drive to attract customer flows - keeping a watchful eye on new entrants who may change the game completely with innovation that outflanks the incumbent derivatives players.