

The trading floor of the future

Will back-office revolution be required to keep pace with front-office evolution?



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You could be forgiven for thinking that in the not too distant future, the trading floor that we all know and recognise could become obsolete. In the ongoing search for liquidity pools, trading could no longer be the domain of larger than life dealers, but instead reduced to being run by PhDs and algorithms. Whilst there is a lot of debate in the market as to what this might mean for the human element of trading, few have given pause to think about the impact on the back office.

You could liken today's front office to the autobahn and the back office to a dirt road. Automation and technology are being fully embraced in the execution space, but trade confirmation and matching are seriously lagging behind. Ever since the SEC took T+1 compliance off the agenda, the impetus for increasing efficiency in the back-office and adopting STP has waned. The question is, will it take another crisis, like the US paper crisis of the 1960s, to drive the market to action, or will securities firms take action as the gulf between front office sophistication and back office inefficiency widens?

Efficiency and regulation

Let's first of all look at the market drivers that are currently shaping the trading floor, and will continue to do so in the coming years. Two main areas are immediately apparent: regulation and cost pressure. Securities firms have long been toiling under a wave of regulation. Whether it's Basel II, Sarbanes-Oxley or now MiFiD, all parts of the securities industry have been touched by the drive to increase transparency, improve controls and decrease risk. And now not even hedge funds are immune - regulators on both sides of the Atlantic are pushing for greater due diligence, increased accountability and tighter procedures.

This regulation has been coupled with ever increasing pressure on costs. Market conditions, increased competition and more educated investors have all put pressure on the securities industry to keep an eye on its bottom line and cope with a squeeze on margins.

Front office innovation - driving the autobahn

So what has this meant for trading? Leading firms have begun to reinvent themselves and are looking to leverage technology to remain competitive in the face of increased pressure from these rising costs, tighter margins, greater regulation and compliance. Innovative use of technology has and will continue to separate the Ferraris from the Fords. Certainly, in the front office, technology is becoming king. The rise of electronic and algorithmic trading is the

clearest representation of this through the confluence of complex technology and diverse trading strategies.

By 2006, algorithmic trading volume will double from its current level to 27% of US equity flow according to a 2004 Tower Group report. Many of the buy-side have adopted algorithmic trading to reduce execution costs through the elimination of broker commissions. A recent study by ITG found algorithmic trading to be, on average, eight basis points cheaper than trading conducted through other means. Not only does algorithmic trading enable the buy-side to execute more quickly and efficiently, but it also allows greater compliance and control of the order. Often, the buy-side uses different methodologies for different types of trading - algorithmic trading for straightforward orders, Direct Market Access ("DMA") for more challenging trades, and agency sales trading for the really tough trades.

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In the main, algorithmic strategies can be broken down into three clear categories; benchmark algorithmic trading against execution standards such as volume-weighted average price ("VWAP"), speciality algorithms to focus on specific trading and more sophisticated algorithms, where the interaction of stocks within a portfolio is considered when conducting a trade. These modern choices offered to the buy-side through the algorithmic phenomenon seem watertight, but there is an Achilles heel in this perfect world. To ensure that the buy-side can benefit from the efficiencies offered by algorithmic trading, the ability to seamlessly communicate electronically with all counterparties is the key.

By working with all parties to the trade and the vendor community, FIX has played a key role in this process. The recent development of the Algorithmic Trading Working Group will take this even one step further. This standardisation serves the interests of both the vendor community and the industry and will ensure that the communication of algorithms is as quick and efficient as possible. After all, front office technology is only as good as the operational technology supporting it and the trade cycle is only as strong as its weakest link.

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The back-office - hitting the dirt road

So far, so good. Firms are stepping up and embracing new technologies to continue the evolution of their businesses. However, the back-office remains an altogether different issue. Much of trade processing, particularly outside of equity trading, remains manual. Trades are processed by email or by fax, even in these times of incredibly sophisticated trade execution.

So why is this the case? Well, often it's just a case of priorities. Firms have limited IT budgets and need to feed a lot of mouths. After the front office is fed, little remains for the back office. There's often a misconception that any investment in STP will mean a large integration project and a large budget - which of course is not always the case. Additionally, costs in the back-office are rarely monitored or measured, making it difficult to quantify the potential cost savings or business benefits associated with STP investment. However, if you take it back to basics, and consider that it costs on average \$28 to process a fixed income trade by fax and \$16 to process an equity trade by fax, compared with just \$4 to process it electronically, the cost saving potential becomes compelling and demonstrable.

And it's not just rising costs, it's the risk associated with prolonged settlement times that need to be taken into

consideration. For example, look at the new jumbo sized 600-seat airplane, the Airbus 380, which is coming on to the market. You may well be able to get more people from airport to airport more quickly, but how quickly will they be unloaded from the plane, reunited with their luggage and transported to their end destination? It's the same with trade processing - execution may happen in nanoseconds, but if settlement is still often a matter of several days is there potentially more risk?

Outsourcing - on the increase

However, despite this lethargy in many areas, it's not all bad news. There are a number of trends that are helping the back-office come up to speed. Firstly, the adoption of back-office outsourcing - both by traditional investment managers to banks and by hedge funds to prime brokers - will act as a significant driver to improving STP across the wider industry infrastructure. Such outsourcing trends are allowing investment firms to concentrate on their core competencies whilst improving operational efficiency.

Alternative asset classes - catching up

Many firms are taking steps in improving their efficiency by automating their fixed income trade processing. These firms are already reasonably proficient with their equity trade management and are now turning their attention to other asset classes in order to realize similar benefits.

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Only a few weeks ago, The Asset Managers Forum published seventeen recommendations to try and ensure best practice STP in derivatives. Some commentators have expressed surprise these have only just been published. The notional outstanding value of the OTC derivatives market stands at approximately \$22 trillion. With hedge funds and pension funds acquiring larger stakes in this market, competition is intensifying. Therefore, the days of manual post-trade processing are seemingly limited. The market seems to be gearing up on all fronts, prepared to address business procedures as well as implementing new technologies. The two must go hand-in-hand, after all, if you automate chaos, you will end up simply with faster chaos.

Front to back - true STP

The securities industry can only become truly automated when there is seamless flow of activity between the front and the back office and further externally to ones trading partners. For instance, the collaboration between Bloomberg and Omgeo leveraging FIX is enabling this to take place with both equity and fixed income trades. Using the FIX 4.4 protocol, investment managers using Bloomberg Portfolio Management System (POMS) can send trade allocations directly to their broker-dealers and automatically generate affirmations for matched trades by using Omgeo's central matching platform, Omgeo Central Trade Manager (Omgeo CTM).

By leveraging an industry standard protocol such as FIX, the Bloomberg POMS /Omgeo CTM interface enables market participants to use existing infrastructures with a common global language to bridge the front and back office.

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Looking in to the future

So what does a look into the crystal ball reveal? The latest survey from research house Financial Insights claims that financial IT spending at Western European banks is set to grow at a compound annual growth rate of 4.8% over the next five years. The research indicated that major growth is expected in the capital markets segment and in the back office in particular. This is encouraging news.

The success of the front office will more and more be impacted by the sophistication of back office systems and as the delineation between front and back office technology blurs this trend will rise. Technology solutions for the front and back office must be run in tandem, both in terms of development rate and integration. Financial institutions that embrace this approach will stay ahead of the pack.

The pressures that are driving technological innovation in the front and by default the back office are not going to

disappear. The spotlight on best practice and accountability shone in the wake of the Enron and Parmalat crises will increase the pressure on market participants to demonstrate flawless paper trails, best achieved through straight through processing. With regulatory deadlines such as MiFID on the horizon, it is easy to see why the robustness of the back office will become an increasingly important feature of the trading floor of the future.

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But there's still a great deal of work to be done. As the buy-side still looks for ways to create greater returns it will continue to use technological innovation to gain a competitive edge. The algorithmic trading phenomenon is living proof of this, and STP adoption now needs to catch up. It's time for the back-office to stand up and be counted and, like its front-office counterpart, embrace this new wave of automation and innovation. **FIX**

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