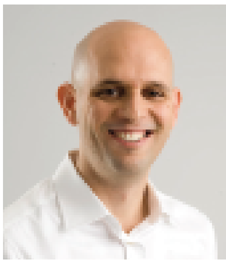

Overcoming FX back-office challenges

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The past decade has witnessed unprecedented growth in trade volumes in the FX market. The market has absorbed hundreds of new participants from both emerging and developed markets, with both banks and non-banks accessing the core market through prime brokerage relationships. Non-institutional buy-side trades have been the largest sector of growth by far, as high-frequency traders, hedge funds, and retail investors have all entered the market and jostled for space.

This sheer growth in size – for example, North American FX trade volume more than doubled in size between 2004 and 2008 – has prompted a repositioning of FX in the mind of the trader at buy-side firms. Previously, FX was simply a way of funding cross-border trades. Now traders have recognised the potential of FX as an alpha-generating activity in itself, and even those who still view it as a funding/hedging activity understand the need to ensure best execution on their FX trades, and the need to stay on top of a much more volatile FX market than that of the past. As opportunities across the FX universe have multiplied, this has brought a new set of challenges, as technological structures in the back office have struggled to keep up with increasing volumes.

The growth in FX volume has coincided with the global financial crisis, which has brought with it a desire to diversify prime brokerage, execution and custodial relationships in order to spread risk and manage exposures more actively, further complicating the clearing process. Add to that the increasing use of automated/electronic execution, model-based and algorithmic trading and the result has been a huge increase in the number of small tickets the back office must deal with. The sheer volume of tickets is rising much faster than the total notional dollar amounts traded, and it is this which is putting back offices under pressure.

Money has naturally been invested in the front office where the immediate impact of a technology investment can be directly and immediately realised in trading revenue; however, a lack of investment and automation in the back office continues to be a challenge. Without sufficient post-trade data processing services, buy-side firms suffer difficulties related to operational efficiency, managing exposure and counterparty risk, operational risks, and high costs of ownership.

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At the centre of these issues is the need to trade with a large number of counterparties, and involve multiple participants in the clearing and custodial processes. This increases the number of participants touching each trade and has meant a shift away from using trade reporting and allocation solutions provided by one firm. Instead, firms find themselves needing to pull together all information into a single repository and manage the reconciliation and post-trade workflows themselves.

Once all the trading activity is consolidated in this manner, firms can then layer on more robust processes for exception management and reporting. For example, orders can be matched against the allocations booked by counterparties, the acceptance status of give-ups to a prime broker can be monitored, and firms can see any trade mismatches or failures in real time. A firm can also implement the same post-trade process for spot, forwards, options and NDFs.

This approach ensures that only good trades reach the back office; it can also unlock scalability in a firm's operations, which can then manage exceptions with confidence that every trade has been examined and matched by an automated process.

In addition, post-trade automation equips buy-side firms for the regulatory, transparency and compliance requirements which seem certain to continue growing. Aggregating trading activity into a real-time repository can help satisfy regulators, particularly for hedge funds and algo trading firms, which continue to be the object of significant regulatory focus in both Europe and the United States.

The coming year will undoubtedly bring new challenges, but the growing attractiveness of FX for the buy-side seems certain to remain. Concerns about operational efficiency, managing exposures and counterparty risk, reducing operational risks and lowering the cost of ownership will thus continue to be central to the buy-side business manager's agenda.

• *Roy Saadon is the co-founder of Traiana*