Rethinking the Middle Office:

Solving Buy-side Challenges with Financial Technology

Once considered simply a conduit between the front and back office, the middle office is playing a more active part in the investment process for buy-side firms. New regulatory mandates require support for collateral management, risk reporting and commission unbundling. Expansion into new geographies and the increased buy-side use of OTC derivatives and alternative asset classes create additional challenges. Firms are also placing a high priority on having accurate, real time visibility into cash, positions and exposures, which focuses attention on how the middle office can support traders, risk officers and portfolio managers more effectively.

While more is being asked of the middle office, fee compression and cost-cutting initiatives have driven some firms to outsource these functions to service providers. But outsourcing introduces new issues, including vendor and operational risk, lack of transparency, and reduced flexibility to maintain established workflows and business practices.

This bobsguide article explores the shifting role of the middle office, and discusses how a unified front and middle office platform can facilitate that shift for firms electing to keep these critical capabilities in-house. Future articles will explore the role of technology in addressing several key middle office challenges, including position management, GIPs compliance, post-trade operations, and collateral management.

Expanding Role of the Buy-Side Middle Office

Growing Role of the Middle Office

The middle office serves as the translation layer between front office investment and back office accounting systems. This frees the front office from having to trade in a particular account structure dictated by their accounting system, while ensuring that the back office receives the data they require. Traditional middle office functions include position management, trade confirmation and settlements, corporate action processing, collateral management, cash and position reconciliation and maintaining the firm's security master.

Several industry trends are driving the middle office to take on additional responsibilities:

GREATER REGULATORY DEMANDS

Dodd-Frank and MiFID II have significantly increased compliance costs and workloads for middle office staff. MiFID II mandates the use of Legal Entity Identifiers (LEIs) by investment managers executing trades on behalf of institutional clients. Sourcing, validating and managing LEIs presents firms with yet another data management challenge. The regulation also requires firms to report trades and transactions across all asset classes to Approved Reporting Mechanisms (ARMs) and Approved Publication Arrangements (APAs).

The middle office is tasked with managing these workflows and reconciling discrepancies with their ARMs and APAs. Additionally, MiFID II mandates that payment for sell-side research must be unbundled from trading commissions. This adds new complexity to the post-trade process, requiring firms to manage research budgets via a Research Payment Account (RPA).

INCREASED PORTFOLIO COMPLEXITY

Years of low interest rates have pushed investment managers into more complex investment vehicles and strategies in an attempt to boost returns. The middle office is increasingly tasked with providing asset valuation services to support front office risk and portfolio management. Pervasive use of OTC derivatives, bank loans and illiquid fixed income instruments in institutional portfolios makes it incumbent on firms to maintain accurate and up-to-date analytics and valuations. This helps risk and compliance officers monitor and understand exposures and ensure regulatory compliance.

GROWING INTERNATIONALIZATION

Unprecedented growth in global wealth has allowed asset managers to expand geographically, especially into high-potential Asian markets. Multiple trading desks and 24/7 operations are increasingly common for even middle tier asset managers. This adds to the burden, as the middle office is expected to align operations with the regulatory and clearing conventions of each jurisdiction, and to maintain a real-time view of cash and positions across desks.

A unified front to middle office solution facilitates collaboration across the organization, eliminates structural inefficiencies that stifle innovation and agility, and makes firms more responsive to changing market conditions and regulatory demands.

GIPS COMPLIANCE

Institutional investors increasingly require asset managers to be compliant with Global Investment Performance Standards (GIPS), a set of standardized ethical principles that guide firms on how to calculate and present their investment results to clients. Maintaining GIPS composites for measuring investment performance has further increased middle office responsibilities and workloads.

Technology Bottlenecks and Outsourcing Challenges

Long viewed as a cost center, the middle office has typically suffered from significant under-investment in technology and infrastructure. Asset class-specific systems and redundant data feeds hamper efficiency and drive up costs. Inflexible legacy systems are often blamed for operational bottlenecks, overreliance on manual processes, and an inability to support new asset classes and instruments.

The resulting infrastructure is inflexible and unscalable for product, customer and regulatory growth, and fails to adequately handle complex investment vehicles and strategies. In response, some firms have outsourced their middle office to service providers offering various levels of functionality. But that approach often introduces new risks and significant integration challenges:

LIMITED FLEXIBILITY

Firms managing even a moderately complex mix of asset classes, products and strategies are often frustrated by the limited “one size fits all” approach taken by service providers. Firms need to perform significant due diligence to determine whether potential outsourcing services truly align with their investment process, asset classes, geographies, and regulatory reporting obligations.

INTEGRATION COSTS

While outsourcing with a state-of-the-art service provider might show a good potential ROI, firms shouldn’t ignore the difficulty of integrating these services with their legacy technology. Outdated front and back office systems often lack support for modern APIs and communication protocols, making integration with a middle office solution untenable or exceedingly difficult. This is especially true for firms using homegrown systems. Having to perform manual data transfers or other workarounds defeats the purpose of outsourcing.

HEIGHTENED OPERATIONAL RISK

Firms considering outsourcing need to examine vendor SLAs carefully in order to minimize operational risk. Ask how quickly the outsourcing service can support regulatory inquiries or resolve collateral disputes. Or whether the vendor will utilize their preferred data sources. Losing the ability to dictate data sources leaves firms vulnerable to discrepancies that then require manual resolution, or even worse, could fail to provide appropriate coverage for the firm’s asset class mix.

Unified Front and Middle Office Technology

A unified front and middle office solution provides a viable and cost effective alternative to outsourcing. Furthermore, firms benefit from system consolidation, improved communication and collaboration, and increased operational control.

CONSOLIDATION

Consolidating disparate point solutions and outdated legacy systems on a single technology platform makes compelling sense. Firms can lower operating costs, eliminate unnecessary system integrations and utilize a shared data model across the organization. Because of their economy of scale, technology vendors are best positioned to ensure that system capabilities keep pace with regulatory changes, new valuation methodologies, and industry trends like expedited post-trade settlement cycles. SaaS-based solutions provide additional benefits, allowing firms to focus on their operating model without the cost and staff required to support technology in-house.

COLLABORATION

While front and middle office delineations vary from firm to firm, traditional boundaries between the two are blurring. This makes sense, in that collateral management, performance measurement, and asset valuation workflows already overlap the front and middle office. While disruptive, the end result is net positive, in that it promotes greater collaboration and communication between these formerly siloed entities. Bringing risk, performance and compliance teams together on a single platform can lead to efficiency gains and improved service levels.

Collaboration increasingly extends outside the firm, as institutional investors and regulators have become far more engaged with their managers, demanding timelier reporting of portfolio performance, exposures and collateral levels.

Maintaining legacy middle office systems and multiple point solutions is no longer viable for asset managers struggling with margin compression and growing regulatory burdens. Even top-tier firms are reevaluating their infrastructure to ensure it meets their needs for scalability, flexibility and interoperability.

OPERATIONAL CONTROL

By keeping their middle office in-house, firms retain operational control over key IP, client and data assets. The pending launch of the General Data Protection Regulation (GDPR) will significantly affect what types of data firms can share with third party service providers, which may reduce the appeal of outsourcing. Eliminating dependence on outsourced services also ensures firms have reliable and immediate access to positions, exposures and cash.

Cloud-based front and middle office solutions also enhance operational flexibility, by providing on-demand scalability, frequent upgrades and enhancements, and extensibility as firms launch new products. Scalability is especially critical for managing and leveraging growing data volumes -- not only reference and pricing data, but information on counterparties, collateral, and unstructured data that may impact exposures or inform front office decision making.

Supporting Growth in a Time of Change

Maintaining legacy middle office systems and multiple point solutions is no longer viable for asset managers struggling with margin compression and growing regulatory burdens. Even top-tier firms are reevaluating their infrastructure to ensure it meets their needs for scalability, flexibility and interoperability. Eliminating disparate systems, improving support for new asset classes and products, and reducing dependence on back office accounting systems are all priorities.

A unified front to middle office solution facilitates collaboration across the organization, eliminates structural inefficiencies that stifle innovation and agility, and makes firms more responsive to changing market conditions and regulatory demands. By keeping middle office functions in-house, firms retain control over critical IP, data and business practices, thereby reducing operational risk. Firms that adopt a SaaS-based solution gain the additional benefits of frequent software upgrades, scalable infrastructure and high quality data.

Conceptually, the front office is the client of the middle office, while the firm's institutional investors are the clients of the back office. This can greatly impact priorities, budgets and the urgency with which technological transformation takes place.