Julia: **A recent poll by Sapient Global Markets found that while the majority of buy-side firms expect their derivatives volumes and trades to substantially rise over the next three years or so, many are not yet fully prepared for the changes to come.**

In this podcast Geoff Cole, director business consulting at Sapient talks to DerivSource about the technologies, market infrastructure, and governance structures they will need to implement.

Here is DerivSource reporter, Lynn Strongin Dodds speaking to Geoff Cole.

Lynn: **Hello, this is Lynn Strongin Dodds. We are talking to Geoff Cole, director of business consulting at Sapient Global Markets. I want to say thank you very much for taking part in our podcast. The first question that I will be asking is based on the recent survey that you conducted with the buy side.**

Was there anything that surprised you in the recent poll that found the majority of asset managers said their derivatives volumes and trades would substantially increase in the next three years?

Geoff: Thank you Lynn, good to join you this morning. I think the results of the survey were generally in line with our initial hypothesis regarding derivatives usage. However, it was good to sort of 'peel the onion' on the industry a little bit better and understand how wide the spectrum of derivatives processing capability was across the industry.

We know things like changing market structure, inclusive of product standardization or things like central clearing are going to be partial drivers of that increased volume. We're aware that the desires of institutional investors are changing and becoming more complex, especially around solutions like liability driven investing, and that's also requiring and driving a broader usage of derivatives instrument types than may have been required in the past.

Lynn: **Why do you think asset managers are still not yet fully resourced to accommodate derivatives?**

Geoff: That's a great question. I think across that spectrum of responses we saw some of the traditional mutual fund houses with decades of history in trading cash equities and bonds are still yet to make the full cultural mindset shift to go beyond the incremental investment and small bits of progress as each new derivative instrument type has been utilized within the investment process.

In reality, what we're talking about here to be fully resourced to support derivatives usage in all its forms across the enterprise will require elements of bringing in external talent and experience, internal investment in education and training of people, as well as revamping of governance models and dedication of project teams to focus on the 6 / 12 / 18 month program of work that's required to optimize the organization to fully support derivatives.

Lynn: **Against that background, how can asset managers prepare for the pre- and post-trade on boarding for new derivatives, including legal agreements and regulatory requirements as well as client services?**

Geoff: I'd separate the answer to this into really two areas, there are some foundational aspects which are primarily internally focused for asset managers where we're talking about developing a business view of the operating model across all geographies and product areas and asset classes, to have the right level of common support services, and we're not just talking about in the trade lifecycle here, we're also talking about areas as you alluded to around legal agreement management and regulatory interpretation incorporation. And then we're also talking about investment in modern data architectures that support breaking or decoupling of the end of day dependency on accounting systems and overnight cycles or custodian data feeds that are quite typical in the asset management industry. And enabling that data architecture with a level of flexibility that allows new derivatives instrument types to be modeled and implemented within front office, middle office, and back office system as building blocks of instruments. We like to think of derivatives as essentially being made up of three main components: futures, options and interest rate swaps, and everything else is just a permutation of that.

Some systems, or some modern data architectures, are much more inclined towards looking at derivatives from that building block perspective. That's really critical towards optimizing the data and technology architecture in support of derivatives and support of that business orientated operating model we talked about earlier.

I would also add that there are also some external considerations that are really important to think about with respect to trading and increased usage of new derivatives instrument types within the client portfolios. What that really requires is a thoughtful or diligent rethink of the client experience and how to create a positive set of interactions across the lifecycle of the client interaction so when new derivative instrument types are considered to be used within existing strategies or in portfolios or when new products are about to be launched, there's elements of education and then creating a long lead time and making clients at all levels feel comfortable with the direction of the portfolio and investment strategy.

We've seen asset managers be successful in this respect, where some of the feedback from an institutional client perspective leads to comments like "It was a very solutions-oriented approach" and it was about figuring out how to get to yes versus a series of assigning tasks or getting lawyers involved early in the process. There was a lot more hand holding and education along the way, and that really created a positive client experience from an external perspective.

***Lynn*: In terms of technology though, you talked about market infrastructure, what type of technology do they need to implement? Do they already have it within their organization? Do they need to build it or buy it? What exactly is the technology needed; a lot of talk about front-to-end systems, is that what you were alluding to, or is it something different?**

Geoff: Yes, it's a little bit of both. There certainly are some systems in the marketplace that have traditionally come from a sell-side heritage and are very strong in the risk analytics and providing real-time views on the exposures and sensitivities of various derivative instruments, but where we've seen the need to invest in some custom development tools in some cases is in the portfolio management and decision support area where essentially the screens and the tools and the method of interacting with portfolios inclusive of derivatives needs to be tightly coupled to the way the portfolio manager and investment teams actually run the investment process.

There really aren't many systems out there that cater to that level of flexibility and variety. So we're seeing the custom route quite popular for the front office set of tools.

***Lynn*: Are they building this in-house or using third parties? What do you think will be the evolution of utilities, which seems to a very popular option going ahead?**

Geoff: I think the asset managers will continue to view their investment process as their competitive advantage. We will see use of third-party service providers to support the development of these custom tools to support in-house capabilities, but that certainly is an area of specialization where asset managers are looking to differentiate and do their own unique thing to leverage their own strengths in investments and reach in front office talent.

The sort of utility or industrialization side of the equation, I think you're certainly seeing things like initial margin calculators and portfolio margin calculators being made available by some of the FCMs and clearinghouses. So for the asset managers it's about how do they leverage the full suite of tools that may be exposed by various service providers across the industry value chain and plug in the respective risk engines and decision support systems, and performance and attribution calculation engines to each of those industry utilities or components where appropriate.

But again, that sort of leads you down the path that suggests the foundational aspects of a robust and flexible data architecture that supports a lot of these changes without a lot of new custom development every time are really critical towards taking advantage of the proliferation of offerings that are available in the marketplace.

***Lynn*:** **Finally, given the level of change, governance is always such an important issue, do they have to change their governance structures as well, or what type of structures will they need to implement to oversee this?**

Geoff: That's a great point. I think governance and the range of committees and working groups and structures that may be involved in overseeing, monitoring, and supporting the implementation and usage of new derivative instrument types is often an area that is overlooked. We do see that as an area of opportunity for optimizing elements of the process, particularly to enable reducing the cycle time between the moment the portfolio manager or product development team has a new idea for a product or trading a new derivative instrument, all the way down to the time that first trade is able to be effective in the marketplace. So governance is an area, which can help compress that cycle time.

The optimal governance structure where elements of best practice is related to governance structure for derivatives includes things like enterprise-wide committees with a mandate for oversight and monitoring and guidance for the long-term derivatives usage and risk management within the firm across all investment products, across all geographies, and that goes across maybe traditional asset class silos.

That governance committee should also be empowered, staffed, and resourced appropriately to be able to conduct sufficient due diligence to understand the operational, legal and regulatory impacts of launching new products that may include usage of new derivatives, or the expansion of existing strategies that may require usage of new derivative instrument types.

There can often be significant heavy lifting and operational due diligence to make that determination, but the governance committees need to be empowered to launch those programs and then ultimately make decisions - 'go', 'no-go' decisions - for products and derivative instrument type trading off the back of that.

Lynn: **Are you seeing asset managers creating these types of committees? I know there's been a lot of talk about it, but do you actually see these type of committees being launched, because the deadlines keep moving so as a result people tend to focus on what's in front of them and not maybe what is in a couple of years' time.**

Geoff: I think definitely that was one of the highlights of the survey: we did see a broad spectrum of sophistication with respect to having an enterprise-oriented committee and empowering and staffing that committee appropriately. The important thing to remember here is the implementation of these changes has only been catalyzed by some of the regulatory drivers, not necessarily mandated by, and so this is more about enabling more robust and efficient product innovation, enabling the full range of exposure, risk and volatility management tools to investment teams, than about responding to a specific regulation.

I think many asset managers have come to that realization and have embarked on not only making some of the operating model and technology investments we discussed earlier, but also in supplementing that with the associated governance changes that we've just discussed.

Lynn: **Thank you very much for your insight, it's been very helpful, and thank you for your time.**

Julia: **Thank you to Geoff for joining us today.**

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