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The Back-Office Risk Race

What did back-offices learn from the crisis that they didn't know?

This article was written by Bob Giffords, Independent and Technology Analyst and published in 2009 for www.swiftcommunity.net/dialogue.

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see inside for details

The financial crisis, they say, changed everything, but it also reinforced some home truths. "First for me, too many organisations looked at risk in a very siloed way – they looked at cards, or mortgages or derivatives trading and their specific risks – they didn't consider risk across the enterprise or across the life cycle of customer relationships," says Thomas Warsop, Group President of financial institution services at Fiserv, the technology solutions provider. "We learned we have to take a holistic approach to risk. People are really asking us for this."

For Luc Meurant, head of banking, supply chain and corporate markets at SWIFT, the back office actually functioned rather well through the crisis. "The weakness" says Meurant, echoing Warsop, "was more due to the fragmentation of the risk management approach and lack of overall control, given the extreme complexity and interdependence driven by innovation in financial products."

The credit crisis has meant significant surges in client volumes for the back office, coupled with an increase in intraday volatility of securities, prices and foreign exchange rates. "Prior and ongoing investments in technology and people during recent years have been key to meeting these challenges," notes David Kane, head of worldwide global custody operations for JP Morgan. When Lehman failed, JP Morgan experienced rapid and sustained increases in client trading volumes, largely reflecting a 'flight to quality' as clients re-balanced portfolios. "Multiple product offerings were impacted and we were pulling consolidated exposure reports on all open transactions on a daily and intraday basis for our clients," says Kane.

"Clear visibility of intraday management information and crisp escalation of potential issues is fundamental to a successful back office operation."

KNOWING WHERE TO LOOK

This need for intense observation stems from fundamental uncertainties. "Often risks are not where you expect them to be," says Giuseppe Balocchi, head of financial engineering and risk analytics at Pictet & Cie's trading division and president of the Swiss CFA Society.

"Following best practice means we avoid the errors of the recent past, but are much more exposed to newer - or older - risks, because we feel so confident."

So what has changed? For a start, management information requirements have become more granular. "Both senior management and regulators are feeling exposed," says Warsop at Fiserv. "They didn't see it coming, but are accountable for the failures, so they're asking for much more transparency from the business with the ability to drill down and see the detail."

Asheen Abbassi, head of alternative investments and derivatives operations at Henderson Global Investors, agrees. "We had robust controls before the Lehman collapse so changes to operational processes have been in the minority," he comments. "What we did achieve was rapidly digestible synopses for those not involved in day-to-day management for back office risks."

Abbassi illustrates how the buy-side is adapting to meet the new risk agenda. "Instead of depositing cash balances with one party, excess cash can be identified and deposited with pre-authorised, stable deposit taking banks," he explains. "Money has the added benefit of being diversified and, where

feasible, on term-deposit to optimise returns. A model developed initially to improve portfolio efficiency is equally beneficial to diversifying risk."

For Kane, "There remains a healthy paranoia in the industry right now, tracking intraday movements of cash and securities." JP Morgan has focused on developing tools which capture SWIFT messages on-line, enabling alerts and rapid escalation when expected movements don't occur. "It's crucial to fix problems as they happen," he argues. Allowing issues to roll over to the next day may lead to a significant exposure. "Our cash sweep products, for example, allow clients to pull together a comprehensive picture of their evolving cash positions intraday, including transactions committed or pending," says Kane. "That transparency can be vital at, say, 4.00 or 5.00pm to decide where cash should be deposited overnight."

However, technology on its own is not enough. "Successful operations need high quality people, subject-matter experts with an end-to-end view of transaction flows," adds Kane.

RENEWED FOCUS ON COLLATERAL

In particular, the way collateral is handled by intermediaries is subject to serious review. Manmohan Singh and James Aitken in a recent IMF working paper¹ presented evidence that after Lehman's bankruptcy, the extent of rehypothecation of collateral declined substantially. While this was due partly to fears over counterparty risk, it reduced market liquidity, they reckoned, by over USD 2.5 trillion in the US banking system alone.

"Clearly collateral management has come to the fore in the crisis," says Balocchi at Pictet. "I give collateral to my broker who passes all or some to his clearing broker, who may pass all or some to a clearing house, all combined with collateral from other clients. How do we unravel it?" People now will forgo returns just to ensure more certainty over collateral."

"There are difficulties involved in preventing the sell-side from rehypothecating collateral," argues Abbassi at Henderson, "as standard ISDA agreements do not cater for this." Upon delivery of collateral securities, the ISDA master agreements give full legal title transfer, so counterparties, if they fail to deliver back the collateral, are only obligated to deliver securities of equivalent quality. "That said, ongoing safeguarding of fund assets is something which the buy-side should be considering across the asset range, within or outside of a prime broker relationship," Abbassi adds.

"Liquidity risk is probably the most important consideration at the moment," says John Trundle, head of risk management at Euroclear, "and as a result there is a huge premium on high quality collateral. Firms are looking to minimise what is pledged and get it back promptly." Euroclear Bank's automated collateral management module

¹ Manmohan Singh and James Aitken, "Deleveraging after Lehman – Evidence from reduced Rehypothecation", IMF Working Paper WP/09/43, March 2009

carries out 16 processing runs a day, round the clock, checking that all eligible securities are used according to the pre-defined terms of the original transaction and ensuring that any margin calls and collateral substitutions are carried out automatically and efficiently. "Firms can also update collateral eligibility criteria in real time to deal with shifts in market sentiment," says Trundle.

"Although total market activity is now down, our triparty collateral management facilities represent one of the fastest growing sectors for us," he confirms. "Our clients want a 'common collateral pool' to cover their exposures across all asset classes, currencies and markets. We go a long way towards realising that model."

THE CHALLENGE OF COUNTERPARTY RISK

"While everyone had processes to handle counterparty risk," says Goran Fors, global head of custody services at SEB Merchant Banking, "it became clear that it was much more difficult than we had presumed. So we had to dig into each market and product to define the risk and the current status, trying better to understand the legal position around pledges or contractual settlement, for example, in the event of bankruptcy. In some jurisdictions it's still not clear to this day."

Assessing one's exposure is complex. "If I make a dollar deposit for a client in New York but a correspondent bank fails while the money is in transit, that's my risk, which may last for only hours or days," says Balocchi at Pictet. "To really understand risk you need to understand banking operations that are very complicated. I think we still have a long way to go here." He notes that aside from the Asian crisis of 1998, no one had seen the failure of intermediaries for a generation. "It came as quite a shock," says Balocchi. "People tended to stick with the big players who they assumed were too big to fail. After Lehman, people are asking who is now too big to fail? There's a real moral hazard."

This has led to much greater pressure for central clearing systems. "In the Nordic region we didn't have a central counterparty arrangement for the equity markets," says Fors. "From the end of this year we shall have one, and of course globally the regulators are pushing central clearing for the OTC markets as well. It will add to costs, but should reduce risks if the unthinkable happens."

The back-office will be under pressure to minimise these economic impacts, especially in the OTC markets. "Where hedge funds typically pay initial amounts, rather like initial margin in an exchange model, the post-integration cost for central counterparties may not be so significant," says Abbassi at Henderson. "For some traditional asset managers where they negotiate out of initial amount settlement, the economics need to make sense and be in the interests of their own clients."

"Central clearing is not a silver bullet," admits Trundle at Euroclear. "Not all securities or bargains are suitable for central clearing, primarily as some more complex asset classes are insufficiently standardised to be liquid. However, where we can, we should facilitate central counterparties as a risk mitigator."

QUANTITATIVE FRAGILITY

At the heart of all of these initiatives is a growing spectrum of quantitative financial models. Paul Wilmott, financial consultant and founder of Wilmott Associates, reminds us that such models constantly need to be challenged. "While some people may now be wiser, demanding bigger profit margins to allow for hidden risks," says Wilmott, "others seem to be compounding their errors by continuing to use the faulty, simplistic models or the over-complex ones that few people understand. Human nature appears to have an aversion for independent thinking and diversity. Most people working in finance are far too dependent on conventional wisdom." So, Wilmott argues, "Either we need executives who can understand the limitations of the mathematics or else we need more scepticism and debate. People must be encouraged to criticise and challenge overly elegant or complex models that don't really account for human financial behaviour."

Balocchi at Pictet agrees a certain caution is crucial. "If anything the crisis has taught us we need to be much more conservative in the valuation of illiquid assets," he maintains. "Instead of trying to measure risks which frankly may not be possible. We need to focus more on risk mitigation; diversifying our risks and providing ourselves with options."

However, diversification too has challenges. "In some markets like Iceland that is more difficult where the whole system fails," says Fors of SEB. "Other countries could face that challenge as well."

Clearly quantitative engineers still have a lot to learn.

REAL TIME HOLISTIC RISK

Automation seems to be key to managing these complex risks. "SWIFT will continue to reduce operational risks going forward through increased standardisation and automation," says Meurant. "The resulting straight-through processing always improves control, reduces errors and relieves cost pressures. However, since cash is scarce, firms are being very selective about what new standards they can afford, given other priorities."

"In recent years we have been consolidating our various tools into enterprise payments, enterprise lending, enterprise fraud control etc. And integrating them together," says Warsop at Fiserv. "Now we're focused on putting an umbrella over those tools and other people's tools, to allow financial institutions to get that holistic view and to manage risk across the business."

SWIFT meanwhile has given users of its network a greater element of counterparty control. "Now, as an example, firms can specify not only with whom they communicate, but also the types of messages permitted for each counterparty," says Meurant. "We are also working on identity management where the objective is to support banks and corporate in identifying not only the business entity but also the individual within the firm that is initiating a transaction."

Such personalisation should help to improve accountability. "However," says Meurant, "our customers' top priority is liquidity risk and cash visibility and here we have seen a strong growth in end-of-day and intraday messages around exposure management for both cash and securities." In the bank-to-corporate arena, he notes, 75% of messages are now position reporting. "There is nothing more important for a corporate than knowing where the cash is," says Meurant.

Warsop at Fiserv agrees. "We need much more intraday information. We have to control transactions in real time and eliminate pockets of manual processing that still lead to errors and delays, he says. "We have to anticipate events, not just react to them."

Sometimes those intraday data feeds need to be mandated. "We're also increasing our controls over trustee or depository accounts following the Madoff affair," says Fors. "We can no longer simply rely on regulatory approvals, but have to do our own due diligence and increase the obligations of the relevant custodians as well to monitor and feedback information."

"Before the crisis we had an enterprise view for operational risk with its models and certain completeness," says Warsop, "and then we had the product level detail, but they weren't joined up. Now we're trying to tie up top to bottom, to build the enterprise views from the underlying detail, not via separate models and historical aggregate loss data. We also want to tie in credit and markets risks as well. Risk itself should not be siloed." Balocchi, for his part, acknowledges that there were many lessons for the back office from the financial crisis. His question is, "How long will we remember them?"

DERIVATIVES WITH COLLATERAL SUPPORT

One of the consequences of the credit crisis on Treasury Operations for many banks is the move by many counterparties dealing in derivatives to require collateral to support some of the underlying exposure. This is typically achieved through execution of a Credit Support Annex (CSA) that forms part of the governing ISDA Master Agreement already signed between the parties.

Execution of CSAs under New Zealand law is a relatively new phenomenon and there are some local features where the practice here differs from other jurisdictions. This is largely due to the Personal Property Securities Act 1999 where some potential risks exist that the collateral could be re-characterised as a security interest, creating less certainty when parties want to enforce their rights over the collateral.

To simplify matters, the approach developing in the New Zealand market appears to be that the parties agree to limit collateral to cash that is denominated in New Zealand dollars. Because of its ease of transferability, it is less problematic to enforce cash collateral compared to securities. This has an operational "win" in that there is no problem valuing the collateral - this is effectively calculated using 100%.

Another operational challenge arising is the requirement to value the derivatives exposure (usually done by the in-the-money counterparty) on a daily basis and then ensure that the figure, which is a key input in the calculation of how much collateral is owed, is agreed between the parties. Clearly the higher the volume of trades executed between parties and the range of derivative products undertaken will create greater deal reconciliation challenges. There are also matters relating to branch and product coverage that need to be factored into the calculation of exposure.

Clearly the world is a different place post-crisis and we will continue to see what this will bring in terms of operational challenges. Suffice it to say that management of operations will continue to be heavily influenced by the action of regulators and market participants both on and offshore and we can expect to see many more developments in the months/years ahead. Watch this space.

FMOA Conference

Date: 21 May 2010

Time: All Day

Location: BNZ, Auckland

Please diarise Friday
21 May 2010 for our next
conference.

Austraclear User Group
meeting

FMOA meeting

Mystery event

More details to come.

Contact person:

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COMMITTEE PROFILES

Peter Barnes

Peter started out on his financial markets operations journey whilst temping in the United Kingdom, back in the early to mid nineties. After gaining this experience in middle and back office operations Peter headed back home to New Zealand where he commenced his career with Westpac. Ten years later, after holding several positions in the back office of Westpac, based in Dunedin and Wellington, he left there and took up the opportunity of leading the BNZ back office. This is a position Peter still holds today.

Peter has been a member of the FMOA Committee for two years and is the current FMOA Chairperson.

Toni Kerr

Manager, Treasury Operations, Kiwibank Limited

Toni has extensive banking experience having worked for global banks such as BNP Paribas based in Hong Kong and Societe Generale in Sydney, among others.

Toni has been a member of the FMOA Committee for two years.

Randy Stack

Head of International Operations & Technology New Zealand

Randy Stack works within Westpac Institutional Bank managing the New Zealand International Operations & Technology teams.

Randy joined the Global International Operations team in 2007 as the Senior Manager Transformation based in Sydney.

Randy is originally from the USA where he graduated from the University of Illinois majoring in both Marketing and Japanese while earning a Bachelor of Science degree in Business Administration.

Andrew Beattie

Senior Manager, Market Operations, ANZ Group

Currently Senior Manager, Market Operations at ANZ. Andrew has spent a number of years at Westpac in a variety of roles including 15 years in institutional operations. Most recently at Westpac Andrew was an Area Manager responsible for a number of retail branches in the greater Wellington region.

Andrew has also spent time working in London and had a two year stint in Fiji responsible for International Operations for the Pacific.

Glenn Curtis

Operational Manager, Custodial Services, ANZ Group

Shortly after joining ANZ Bank in late 1987, Glenn transferred from general banking to a back office role in Funds Management where he spent three years, before travelling overseas. While living in Cornwall, England he worked in roles outside of the financial services industry.

Upon returning to NZ in 1994 Glenn rejoined the bank's Custody team, initially in a Settlements role, followed by various Corporate Action roles. In recent years he completed a graduate diploma in Information Systems through Massey University, and his current role is operational manager for the NZ business.

Glenn is a new member to the FMOA Committee.

Jen Angus

International & FI Settlements Supervisor, First NZ Capital

Jen has been working in settlements for 11 years in a variety of jobs starting with Charles Stanley & Company (formerly Torrie & Co Stockbrokers) in Edinburgh. Jen came to New Zealand for an OE and started working for First NZ Capital in 2004 to present. Jen forgot to leave after her year was up.

Warren Bland

Head of Equity & Fixed Income Settlements, First NZ Capital

After doing a small OE of seven years, Warren returned to New Zealand to do a BBS (Finance) at Massey. Warren has been working for FNZC settlements for five years.

Jen and Warren are two of our newest members on the FMOA Committee.

Patty Bow of HSBC, Rebecca Murphy of RBNZ, Elizabeth Mak of National Nominees and Martyn Bain of NZX make up the remainder of the FMOA Committee.

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