FMOA
FINANCIAL MARKETS
OPERATIONS ASSOCIATION

IN THIS ISSUE

AGENDA

FMOA CONFERENCE and AUSTRACLEAR USER GROUP MEETING

Friday 25 November 2005

Featherston Room, Hotel InterContinental
Grey Street, Wellington

10.30am – 11.00am
Morning Tea
(SWIFT User Group attendees)

11.00-12.30pm
SWIFT User Group Meeting
Martin Morris, Westpac

12.30 – 1.30pm
Lunch (Austraclear/FMOA members)

1.30pm – 2.15pm
Austraclear Users Group Meeting

2.15pm – 2.30pm
FMOA Annual General Meeting
Robert Poulter, Chairperson
Paul Chandler, Treasurer

2.30pm-3.15pm
Demonstrating Continuing Competence and Building Industry Confidence
Andrew Bell, Proficio New Zealand Ltd

3.15pm – 3.30pm
Afternoon Tea

3.30pm - 4.15pm
Accreditation and Training in New Zealand
Craig McIvor, AFMA Services

4.15pm – 5.15pm
"Make It Happen" with Billy the Kid
Billy Graham

5.30pm – 7.00pm
Drinks & Nibbles for Austraclear/FMOA members, operations and settlement staff at same venue.

NZ FMOA Chairperson's Report

The past year has been a rollercoaster ride for both the World economy and the World itself, starting with the devastating Tsunami in December and culminating with the earthquake in Pakistan. Thousands of lives have been lost, millions of people have lost their homes and livelihoods and the economy of the affected countries have been stripped to the bone. The countries affected were not always the poorest, with the United States suffering after New Orleans was all but wiped off the face of the planet.

The events that have taken place over the past year have also affected us closer to home. Petrol prices have increased significantly, even to the point where people cannot afford to fill up their cars. Salary rates have not been able to keep up with these increases, nor with the prices of housing. For sometime now we have heard talk of house prices easing or in some areas falling by up to 10%. Looking at prices in the main centres we still have not seen these expected decreases, with some centres still on the climb. The Reserve bank had held the OCR at 6.75% for the majority of the year but this increased to 7% last week.

This year has also been a turnaround year for the Labour Government. In the recent election there was a huge swing to the Don Brash led National Party which saw Labour struggling to form a coalition Government. Labour pulled this feat off with the help of Winston Peter's New Zealand First party. Even though Winston did not hold on to his seat in Tauranga, he did manage to get the Foreign Affairs portfolio. This election also saw the Maori party win a landmark four seats in Parliament.

One thing this year has shown us is that change, and the reaction to change whether it be positive or adverse, is an important factor in our lives. To keep ahead of our competition we need to adapt quickly to meet the market and the needs of our clients. The forthcoming year is going to bring more regulatory change, especially surrounding Money laundering and the funding of terrorist organisations..

The FMOA Conference has also changed, reducing to half a day. But by reducing the time we have not compromised the quality of our presenters. This year's conference sees presentations by Billy Graham, Andrew Bell of Proficio New Zealand Limited and Craig McIvor of AFMA Services; the latter follows the FMOA's drive for accreditation in the New Zealand market.

The other change will be the appointment of a new Chairperson for the FMOA as I have been transferred to Melbourne to take up a position within National Custodian Services. This has probably been the shortest tenure of a Chairperson, but it has been a very eventful one. I am sure that you will continue to support the new Chairperson and the FMOA and see them as a valuable commodity in the NZ market place.

Thank you for your support and good luck for the future.

Robert Poulter
FMOA Chairperson

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Coming Soon – Online Education for SFE Austraclear users

SFE Austraclear is pleased to announce the forthcoming launch in November 2005 of the AClear Education program.

AClear Education is an online training program for the SFE Austraclear replacement system designed exclusively for system users. The program will be delivered through the SFE website and will consist of 14 courses with each course containing a variety of learning material:

A detailed manual which can be printed or downloaded for future reference,
Visual demonstrations which show users how to perform functions within the new system, and can be used to refresh your memory as well as to learn new skills,
A multiple choice examination based on the material contained within the manual and demonstrations

Once users successfully complete a course, they will be able to view and print personalised "Certificates of Achievement" from the website which will include details of all courses they have successfully completed, to prove to current or future employers that they have the required knowledge to pass this examination.

For both novices and experienced SFE Austraclear users, the program will have something for everyone. In addition to the courses, the site also contains a Reference Library tailored to the Clearing and Settlements industry containing:

Glossary of industry terms
Glossary of SFE Austraclear system terms
System hints, tips & shortcuts and
Relevant Industry articles and publications

AClear Education has been developed to offer SFE Austraclear system users choice – being online it is flexible, fast and convenient, and allows users to take as many courses as they wish, in any subject they wish, whenever they wish - at the office or at home, 24 hours a day, seven days a week.

Joining the program is free of charge, and after completing a simple registration form, users can access the website and start to benefit from this essential information source, tailored specifically to their needs and available at their fingertips.

All users of the current SFE Austraclear system (FINTRACS) will receive an information pack with details of how to enrol, however new users can also join the program at any time by logging on at www.sfe.com.au/acleareducation

For more information on AClear Education visit our website www.sfe.com.au/acleareducation from 30th November 2005.

In addition the completion of courses can earn you Australian Financial Operations Association (AFOA) Continuous Education (CE) hours. For additional information about AFOA and the accreditation program please refer to www.afoa.com.au

"The Program will have something for everyone"

Setting New Standards in Performance Measurement through AFOA

The AFOA Performance Measures Working Group (PMWG) was established in the 1st quarter 2005 with a mandate to establish market standards for performance measurement in Financial Markets operations performances. Data will include deal confirmation, deal input errors, cancellations etc. The group is represented by a number of local and offshore financial institutions.

The PMWG is currently developing a series of performance measurement criteria which AFOA members will be able to utilise to;

Gain a better understanding of their exposure to operational risk,

Benefit from a greater ability to anticipate operational issues,

Provide criteria to challenge current reporting ensuring market consistency and relevance
and;
Suggest criteria for which the data collection process can be made more robust

PMWG Work to date has focused on the review of industry papers from organisations such as the Federal Reserve and ISDA in conjunction with the collation of data from working group members. As a result of this review the PMWG aims to have finalised a draft set of performance measurement criteria by the end of 2005.

Extracted from the Article

The Changing Nature of Operational Risk in Foreign Exchange

Dino Kos
Manager of the Sydney Open Market Account and Executive Vice President, Markets Group, Federal Reserve Bank of New York.
Member, The Foreign Exchange Committee

The rapid pace of change in the foreign exchange market has created a number of new opportunities for profit. New trading methods, new customers, and new products reflect the dynamism of what continues to be the largest marketplace in the world. The heady pace of innovation shows no signs of slowing, and taking advantage of these emerging possibilities requires agility and speed.

However, while innovative products and ways of trading create new possibilities for profit, they also introduce novel and sometimes unfamiliar operational risks that must be identified and managed. Failure to do so can, and in recent years has, resulted in large and publicised financial and reputational consequences that linger long after the loss is recognised in financial statements.

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Operational Risk Defined

Traditionally, operational risk in financial institutions has been defined as the risk of loss from breakdowns associated with the confirmation, netting, settlement, and accounting of financial transactions. In short, this definition was about "back-office" risks. However, in recent years the concept has broadened e.g. the Basel Committee has defined operations risk as the risk of direct or indirect loss resulting from inadequate or failed internal procedures, people, and systems or from external events.[1]

A review of recent events highlights the many ways that operational risk exposures can manifest themselves. The events of September 11 and the 2003 blackout in the United States directly affected financial institutions' front and back-office capabilities by disrupting or delaying trade execution, confirmation, settlement, and netting services. Other examples include the large foreign exchange trading losses at Allfirst Bank and the National Australia Bank (NAB), which resulted from the breakdown of fundamental internal control processes, including weaknesses in the segregation of duties, trade confirmation, control of system access, and review of off-market trades.[2]

While reputational risk is not considered part of operational risk for Basel risk capital purposes, the two types of risk have become increasingly intertwined. Lapses in the operational control environment generally result in immediate and direct losses – as demonstrated by the Allfirst and NAB cases.[3] However, the damage to a firm's reputation and the potential decline in business activity associated with such lapses could persist and potentially outstrip the original "headline" cost. Thus an investment in control and operational risk capacities can more than pay for itself.

Operational Risk in Foreign Exchange

Operational risk in the foreign exchange context centres on processing, product pricing, and valuation.[4] Failure to appropriately manage operational risk can reduce an institution's profitability. Incorrect settlement can have direct costs in improper payments and receipts and in addition trade processing and settlement errors can lead to significant indirect costs, such as compensation payments. Furthermore, investigating problems and negotiating a resolution with a counter-party may carry additional costs.

"The heady pace of innovation shows no signs of slowing"

Operational risk has another unique characteristic. In contrast to credit and market risk it has proved very difficult to quantify. Many institutions employ additional operational risk management tools, such as key risk indicators and control self-assessment programs. However, determining expected losses, given the uncertainty of those losses is much more complicated for operational risk than for other risk categories. Basel II represents an effort by the industry and regulators to develop creative approaches to capture this elusive concept.

Given these challenges, senior management vigilance, a robust control culture, and individual ethics assume heightened importance. Together, the board of directors and senior management should develop and periodically review the operational risk framework. Moreover, senior management must reinforce an institution's formal policies and procedures with a strong control culture. An independent, accountable, and sophisticated audit and/or risk control function with director reporting lines to senior management is a critical element in fostering a climate of control. Incorporating the results of audit and compliance reviews into a manager's compensation can also demonstrate that operational risk management is an institutional priority. The importance of attracting ethical staff and developing (and enforcing) an appropriate code of conduct cannot be overstated. The supervisor's and auditor's reports regarding the recent events at NAB, highlighted the significant costs associated with weaknesses in any or all of these factors.

Recent Trends and Challenges Ahead

The most recent Euromoney poll indicates that market share remains heavily concentrated, with roughly half of the total market in the hands of a small number of players. Average daily volume in traditional foreign exchange instruments reached $1.9 trillion in 2004, compared with $820 billion in 1992.[5] As a higher volume of transactions flows through a smaller number of participants, operational risk has become more concentrated.

With respect to operational and processing developments, the introduction of CLS Bank in 2002 marked a major milestone in the private sector's effort to minimise foreign exchange settlement risk, with gross trades settled through CLS averaging $1.6 trillion per day in November 2004. CLS has certainly increased efficiency of settlement by introducing a mechanism for simultaneous exchange of currencies on an intraday and multilateral basis.

Events in recent years have highlighted the importance of robust contingency planning for all foreign exchange market participants. Overall, the industry responded quickly and efficiently to the events of September 11, 2001. However the experience emphasised that contingency planning could be improved. The increased interdependency among market participants has heightened the need for firms to integrate their business contingency plans with those of key liquidity providers, utilities, and clearing and third-party settlement banks to ensure that everyone is operating under the contingency assumptions.[6]

Financial institutions' interest in outsourcing continues to expand beyond the outsourcing of mainframes and data networks to include various business processes, such as back-office and accounting and finance functions. While a firm may outsource day-to-day processes, its responsibilities for complying with internal, industry, and regulatory standards are in no way diminished. Moreover, relationships with outside service providers expose firms to new risks that must be managed. An institution should establish procedures to monitor service providers to ensure that they are performing functions according to agreed-upon standards and practices.

Conclusion

Like the market itself, operational risk in foreign exchange is fluid and dynamic. As the nature of the industry's participants, products, and technology evolves, it is critical that managers understand the operational cycle, commit to adopting best practices to manage operational risk, and instill a culture of awareness and control throughout their institutions. Whether it's a major dealer, hedge fund, corporation or central bank, a firm that thinks that it cannot afford, or skimps on appropriate risk management infrastructure should expect to pay a price in the long run.

Investment in risk control on an individual-firm level will also benefit the market as a whole. As participants pursue their common self-interest, the overall efficiency and effectiveness of the market will be served by the implementation of sound operational risk management practices.

1 Bank for International Settlements, Basel Committee on Banking Supervision, Operational Risk Supporting Documentation to the New Basel Capital Accord (Basel: BIS, 2002), p.2.
2. PricewaterhouseCoopers, Investigation into Foreign Exchange losses at the National Australia Bank (PricewaterhouseCoopers, 2004), pp.1-2; Promontory Financial Report and Wachtell, Lipton, Rosen & Katz, Report to the Boards of Directors of Allied Irish Banks, P.L.C., Allfirst Financial Inc., and Allfirst Bank Concerning Currency Trading Losses (Promontory Financial Report and Wachtell, Lipton, Rosen & Katz, 2002), pp. 1-2
3. PricewaterhouseCoopers, Investigation into Foreign Exchange Losses, pp. 1-2; Promontory Financial Report and Wachtell, Lipton, Rosen & Katz, Report to the Board of Directors, p.29.
4. .Foreign Exchange Committee, "Management of Operational Risk in Foreign Exchange," in 2003 Annual Report (New York: Federal Reserve Bank of New York, 2004), pp.11-66.
5. Bank for International Settlements, Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in April 2004 – Preliminary Global Results (Basel: BIS, 2004), p.9.
6. .Foreign Exchange Committee, "Contingency Planning: Issues and Recommendations," in 2001 Annual Report (New York: Federal Reserve Bank of New York, 2002), pp.45-7.

E-Commerce and Banking - Where To From Here

"The money screamed across the wires, its provenance fading in a maze of electronic transfers, which shifted it, hid it, broke it up into manageable wads which would be withdrawn and redeposited elsewhere, obliterating the trail." as selected from Nest of Vipers, a financial thriller by Linda Davies.

Money, originally a physical substance, like gold or alive (e.g. cattle) is today used by individuals in their everyday transactions as either notes, coins or cards. However it's quantity is small in comparison with the intangible money that exists only as entries in bank records.

> **"The money screamed across the wires "**

While traditional payment mechanisms such as credit cards work today, it is unlikely they will be sufficient in the future and in reality it is electronic payments capability that is crucial for the development of electronic commerce. Banking providers today are very different from retail banks of 20 years ago. Moreover, consumers are prepared to buy financial services from non-traditional providers, potentially with no history in financial services. Thus, customers are benefiting through access to new more cost effective channels that also offer greater flexibility.

Fortunately for traditional banks, some banking products are more suited to e-commerce than others. Generally, simpler products and services (i.e. transaction and account based) tend to be better suited to Internet delivery, partly because of the regulations and partly multi stage processes that often surrounding more complex products.

Future models

Experts suggest portals and informediaries (websites that promote and sell product sourced from many suppliers) are likely to play the largest role in the future of Internet banking. If so, these models will progress a shift in power from the seller to the buyer, reinforcing the current situation where consumers are developing greater control. The resultant pressure on prices and speed of service for customers can only increase as a result. Interestingly, successful sites are focusing on the only measure that really matters: lifetime customer value, with the best-performing sites, attaining a customer conversion rate of 12% and a repeat-purchase rate of 60%.

Future potential

Researchers and entrepreneurs alike are continually breaking through the initial barriers and are able to unlock the power of this medium, suggesting there is no telling what will happen. An example of this is the Electronic Wallet (a.k.a. the digital wallet or e-wallet), in its simplest form, it is a digital file that can be downloaded onto the consumer's desktop. When it is time to conduct business online - be it ordering an airline ticket, or renewing a car registration – consumers activate their wallets, which then enter credit card, billing, and shipping information onto a point-of-sale form with a single click. However even the most basic wallet doesn't stop there. While providing relief from repetitive typing, wallets can also help consumers compare product prices, keep track of their purchases, and store information.

On one level this type of transactional concept seems far fetched. However with the advances in technology moving at what appears to be an ever increasing rate, it certainly makes you think doesn't it?

Phil Currie
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