Automating the derivatives dilemma

Derivatives are booming, say Alan Horton-Bentley of FileNet.Corp and Christopher McLaughlin of Thunderhead, but so is the pile of trades awaiting processing. If the efficiency funds require is to be attained, and regulators are to be appeased, then it's time to press 'enter'

The rapid expansion of derivatives products has become an area of interest for regulatory agencies such as the UK FSA and Federal Reserve Bank of New York. The reason for this attention is that, over the past few years, the backlog of unconfirmed derivatives trades has increased at an astonishing pace.

As volume of trades has grown, financial institutions have found established business processes insufficient to manage these vehicles. Such operational issues drain the profitability of these highly lucrative financial instruments and exposing institutions to greater operational risk.

To date, the regulators have adopted a collaborative approach and worked with the leading banks to address specific areas of concern.

The result has been a renewed impetus among market participants to consider methods by which they could increase trade confirmations automation and decrease the backlog of unconfirmed trades.

Industry initiatives, such as the impending introduction of The Depository Trust & Clearing Corporation's (DTCC) central industry trade information warehouse, which will provide one central source for trade lifecycle data for the market, will add further pressure on banks to address this issue. To participate in such initiatives, it is essential for trading institutions to get their houses in order in terms of the accuracy of their trade data and confirmations.

Under pressure from regulators who have expressed concerns that improperly documented transactions pose a significant market risk, banks have already made an extraordinary effort to catch up and clean up, specifically in the area of credit derivatives.

Nevertheless, at the end of May, International Swaps and Derivatives Association (ISDA) reported that errors were still on the rise in some asset classes. The ISDA *2006 Operations Benchmarking Survey* found that one in every five credit derivatives trades made by big dealers initially contained mistakes, while the errors in trading equity derivatives more than doubled last year to 20%.

In addition, Society for Worldwide Interbank Financial Telecommunication (SWIFT) estimates that 59% of trade instructions require reworking. Consequently, many firms continue to generate confirmations manually, requiring higher staffing levels and making it increasingly difficult to handle any fluctuations in trade volumes.

Derivatives trading firms have no choice but to pursue strategies that maximise automation wherever feasible, while accommodating manual exception-handling for complex products, if they are to avoid regulators mandating the same.

In doing so, they will also ensure capacity for continued market growth.

But doing so demands a strategy that integrates business process, content management and document generation.

A SYSTEMATIC APPROACH

The intrinsic complexity of derivatives products, the growing varieties of products, and increasing instances of exceptions has made the goal of straight-through processing (STP) more challenging in the derivatives arena than in other areas of trading.

In addition to enabling STP for the majority of vanilla trades, organisations need to look for solutions that adequately support the non-STP requirements of more exotic trades without the need for a separate operational process.

Beyond decreasing immediate operational risk, an approach that integrates process, content and document generation has proven to support organisations' long-term strategic objectives of achieving STP.

AVOIDING THE PAPER CRISIS

Rapid market growth and the constant attention of regulators has placed substantial pressure on derivatives operations for verification, confirmation and legal execution of OTC derivatives, and has increased expectations for counterparty personalisation and delivery channel flexibility.

These developments, coupled with the movement toward electronic matching of trades, have led many companies to turn to technology to avert a paper crisis. The danger of such a crisis can be avoided by the application of relevant technologies to address each step of the trade-confirmation process and the effective management of all types of critical trade information and documentation.

PARALLEL PROCESSING

Derivatives-trading firms that adopt an integrated approach to systems and processes can turn what has traditionally been a linear, fragmented process into a collaborative, parallel-processing environment, increasing efficiency, reducing costs, and freeing key staff to concentrate on higher-value activities.

Previously, efforts towards achieving STP objectives and improved exception management have been undertaken independently, with one effort emphasising automation and the other, the co-ordination of input from a variety of parties, including legal, operations, traders, and counterparties.

Most firms simply assumed that solving these issues required distinctly different approaches.

By applying today's business-process and content-management capabilities and integrating the 'exception' (non-STP) trade confirmation review process and workflow, including automated routing, follow-up and escalation, within a single document-generation environment, companies can utilise the same systems for all trades.

ADDRESS COMPLIANCE IN ADVANCE

The proliferation of new document-delivery channels including DTCC, FpML, and email have created additional burdens for the derivatives operations process. As well as addressing capacity-management challenges through automation, solutions for derivatives trade confirmations should also assist with managing compliance.

Intelligent derivatives trade confirmation systems must therefore accommodate all delivery formats to future-proof the platform and simplify transition to new methods and requirements.

Because of the sheer volume of trade confirmations organisations have to manage, regulators see automated market systems as an important solution for protecting against the threat of systemic breakdowns in the derivatives market.

Trading organisations need to ensure their solutions leverage technologies that are able to improve operational efficiency, as well as provide a complete audit trail of content use.

This approach to document generation also minimises the strain on information technology staff by placing the control and capabilities for document creation, revision and testing in the hands of the most knowledgeable parties, members of the derivatives operations team.

By automating the use of company-defined business rules, firms can ensure compliance across all jurisdictions and enable real-time process and exception audit for adherence to legal and self-regulatory requirements.

Straight through processing and improved exception management are critical to sustaining the ongoing profitability and attractiveness of derivatives. The future of the industry depends on leading trading institutions taking proactive steps today towards automation.

Although a crisis does not appear to be imminent, this is a key imperative if firms are to avoid additional regulatory pressures and ensure the ongoing viability of these financial vehicles in today's sensitive market environment.

AUTHORS

Alan Horton-Bentley is director of worldwide industry marketing – financial services at FileNet Corp. Most recently, he served as president for RegCom Associates, a management-consulting firm specialising in compliance, regulations and practices for the financial and recruiting industries.

Before that, he was chief executive officer of Xcel Banking systems.

Christopher McLaughlin is chief marketing officer at Thunderhead, overseeing its global marketing strategy and operations. He is also responsible for developing strategic relationships worldwide.

Before joining Thunderhead, he was vice president of product marketing at FileNet Corporation a software company in the ECM market.