SUNGARD ADAPTIV

Risk Management
and Operations
Solutions

Eliminating Back-Office System Fragmentation – A Practical Approach

The issue of automation, or rather the lack of it, has long been a concern in the financial services industry. The operational and risk management benefits of straight-through-processing (STP) are well documented but the application of automation has been far from universal.

The issue of automation, or rather the lack of it, has long been a concern in the financial services industry. The operational and risk management benefits of straight-through-processing (STP) are well documented but the application of automation has been far from universal.

Where automation has occurred, it has been along business lines and specific asset classes. Furthermore, it has been concentrated on the vanilla parts of the market – those instruments that are largely commoditised and volume-driven, thus leaving the less traded and more exotic, higher margin products to existing and often manual processes.

There is a clear difference in priorities between front and back-office technology. Front-end systems are designed to be light and nimble, enabling trading staff to react quickly to market developments and new products. In contrast, back-office systems are more ponderous in nature. Implementing the changes needed to accommodate new products in the back-office present different challenges, such as the payments function, the creation of documentation and the associated administration plus the most complicated of all of the processes – the accounting for new products.

A frequent consequence of the disparity between back-office and front-office functionality combined with a lack of automation in new products is that trading desks are hampered in their efforts to introduce new products. This is most starkly evident in the latest Operations Benchmarking survey produced by the International Swaps and Derivatives Association (ISDA)*.

The ISDA survey shows that, while considerable effort has gone into enabling the straight-through-processing (STP) of credit derivatives, the level of automation in interest rate swaps has actually decreased. Much of this stems from the failure to resolve exceptions so that they can be easily dealt with the next time they occur. In the end, the value of STP is greatly enhanced the larger is the share of exceptions that can be resolved in an automated fashion.

System fragmentation

System fragmentation is an inevitable consequence of the demand for the front office to be flexible and nimble to remain competitive. Often this is achieved by installing dedicated systems for specific asset classes. This usually occurs due to the lack of existing systems within the institution able to accommodate a new product.
The acquisition of several disparate systems for single asset classes usually leads to duplication of processes. A cash settlement is a cash settlement regardless of the underlying instrument but payments are being processed on several separate systems rather than being consolidated on one enterprise system. The fragmentation of systems means that the commonality of the payment process cannot be leveraged across the organisation. The result is an increase in cost as staff are first trained and then deployed on new systems developed for each new instrument. Furthermore, internal cash payment netting opportunities are lost when data cannot be effectively aggregated across systems.

Of course an institution may choose to avoid trading a particular instrument if the cost of processing is prohibitively high but this is rarely a viable option. New products typically carry higher margins, making them attractive for traders, and their unique features make them attractive to end users. Clearly it does a bank no good for either its revenue or its reputation if it is making trading decisions based on the cost of processing or the extent of back-office re-engineering required.

Different institutions have different criteria as to when the cost and operational risk of manual processing becomes prohibitive or the volume of trading required is simply too great for a manual approach. When a decision to automate arises, it can rarely be made in isolation. Automation is critically dependant on standard reference terms and is the first step towards STP. Once counterparties agree on terms and conditions for new transactions and utilize the same structure for documentation a major obstacle to STP has been removed. Reaching this stage, however, requires a concerted industry-wide initiative.

Frequently instruments are simply too complex to be standardised in this fashion. In these instances, automation will always follow innovation. In today's markets, these complex, structured products are becoming the norm among innovative new offerings. Not only that, but these new complex instruments are being traded in rapidly increasing volumes by ever more market participants.

Added to this is the intense demand to bring these new products to market in as short a lead-time as possible. As new products appear, the first tendency for banks is to process them manually through a simple Microsoft® Word document or Excel spreadsheet. At this early stage, a bank cannot be certain that the new instrument will trade in significant volume for an extended period of time. In light of this, most institutions are understandably reluctant to commit the resources needed for an automated solution.

Operational risk

The proliferation of manual processing for new products creates a growing concern about the accompanying operational risk. When trade details are copied from a piece of paper and typed manually into a Word document, the potential for error is huge. Recording erroneous trade details can result in a failed settlement and/or faulty payments. Furthermore, because such trades are processed outside of the bank's central systems this often means they are not subject to the normal checks and balances, limits and validations applied to the rest of the institution's transactions.

Awareness of operational risk has increased dramatically over the past eight years with the introduction of regulatory measures such as Basel II and Sarbanes Oxley, which place a specific emphasis on the importance of measuring and mitigating such risk. Other sources of accumulating regulatory pressure include anti-money laundering rules, new accounting standards (IAS39 and FAS133) and the restructuring of the securities market in Europe through MiFID, all of which are intensifying the pressure for businesses to improve their operational discipline.

Why not use a single system?

A single platform covering all asset classes and offering front-to-back support is a subtly attractive proposition and is the goal of many banks seeking tomorrow's solution. Indeed, it is the approach adopted by many solution vendors. So what is wrong with it?

Most obviously, no such system exists today. More seriously, the pace of new product development makes it highly unlikely that such a system will exist in the future. A single monolithic system, even if it had the required functionality, would almost certainly lack sufficient agility to meet the time-to-market demands of today's business.

Lack of agility is even more pronounced when a system has been built in-house. On the other hand, users of third-party packages are dependant on vendors being able to address any shortcomings. As new products need to be accommodated, patches and workarounds make the original monolithic structure start to resemble the multiple-platform infrastructure it sought to replace, only with slightly fewer systems.

Most important of all, such a single system model implies that the front-office trading desks must operate within this one environment. In consequence, the business must accept that it will not undertake transactions that cannot be directly supported by the single system, at least in any volume. Realistically, this is an untenable constraint if the trading unit is to remain competitive. The simple reality is that a bank will always have multiple trading platforms and adjusting to this situation is essential to effective trading risk management.

The solution

Multiple platforms need not prevent a common middle- and back-office environment. An alternative is a system that sits between the front- and back-end systems and translates all the trade information from the front-end into a format that can be understood by the back-office system.

In order to achieve this commonality and consistency a key principle must be adopted by the bank, namely product agnosticism. Ensuring that cross-asset functions remain product agnostic and do not operate on a fixed product list means that the product type involved is immaterial to the data being fed into the system. For example, settling a cash flow from a derivative would be the same process were it an FX trade or an interest rate swap. It is just a cash flow that needs to be settled. Using a silo approach, the product type dictates how a cash flow is processed and how complex this task is depends on the level of automation within that asset class. A product agnostic approach creates a consistent set of functions across the enterprise all defined by business rules rather than product type. Payments are payments, a cash settlement is a cash settlement and all processing need occur only once.

The commonality of functions removes the duplication of processes, dispenses with redundant platforms and reduces the dependency on manual intervention, consequently reducing both operational costs and operational risk.

From the perspective of the trading business, banks can reduce the number of systems used and trading platforms can be selected based purely on the requirements of the front office rather than the ease with which they can be integrated into a bank's back-office infrastructure. Above all, this product agnostic approach gives banks a future-proof environment where new products and front-office platforms can be added quickly and painlessly without having to change the back-office infrastructure.

The benefits are clear and significant but important changes are required to reap these benefits. To accommodate this product agnostic approach, it is necessary to implement an infrastructure that will enable banks to be more agile and consistent in their business processes. More than just practical technology work is involved. There is also a necessary change of philosophy and culture in going from a multiple, siloed approach to a single, product agnostic infrastructure.

Overcoming obstacles

The fear of such a change is a debilitating factor for most banks as is the initial investment involved and attitudes can be difficult to change. Many managers still think that if they have a new front office system then they need the same back-office system in order to make it work. The integration work needed can also be daunting.

Overcoming these obstacles, however challenging, is imperative in today's market and the need will only become more urgent as new products, time to market, cost pressures, regulatory requirements and the intensity of competition continue to increase. In short, banks must realise that they can no longer put off until tomorrow the task of beginning to rationalize an increasingly dysfunctional back-office infrastructure.

For more information on SunGard Adaptiv, please contact us at: adaptiv.marketing@risk.sungard.com
Visit www.sungard.com/adaptiv

** ISDA Year-end 2006 Market Survey published 18th April 2007*

www.sungard.com/adaptiv

SunGard Adaptiv
25 Canada Square
London
E14 5LQ
United Kingdom
Tel: +44 (0)20 8081 2000

SunGard Adaptiv
560 Lexington Avenue
9th Floor
New York
NY10022
USA
Tel: +1 212 745 9400

SunGard Adaptiv
8 Temasek Boulevard
#39-02/03 Suntec Tower 3
Singapore 038988
Tel: +65 6227 6400