Guest Editorial

Will derivatives processing ever be truly automated?

Journal of Derivatives & Hedge Funds (2009) **15**, 1–2. doi:10.1057/jdhf.2008.26

A recent Aite Group report into OTC Derivatives processing highlighted why many firms are struggling, characterising current processing environments as ‘too many hands in the cookie jar’.

In other words, trades are being handled by multiple staff members in different functional areas and with different tools. In today’s markets, with OTC contract volumes rising at 20 per cent year-on-year that level of duplication and inefficiency is unsustainable.

There is a perception that it is difficult to define normal practice when derivatives contracts can differ so greatly. It’s also often stated that the OTC market lacks standards but that isn’t the case; they exist but haven’t yet been taken up by all market participants to truly deliver the automation that’s required.

Further, automation and the drive towards greater straight through processing (STP) for confirmation and settlement of certain derivative instruments are becoming mandatory. This will only increase as the buy-side uses market infrastructures such as SWIFT, Markit Wire, DTCC Deriv/SERV and T-Zero, who have created a number of services using FpML as the *de facto* standard for communicating trade data.

Firms also need to follow best practice guidelines. Effective transaction management requires back office staff to track the trade status as it moves through its lifecycle.

OTC Derivatives add further complexity due to their unique nature, which requires ongoing monitoring such as periodic or regular payments that must be calculated to take into account rates resetting.

We have seen plenty of buy-side firms struggling to manage the novation process in credit derivatives due to using a combination of paper-based files and Excel spreadsheets that have led to failed settlements. As a result they could not identify their counterparty and their back office teams spent time and effort tracking down a specific instrument after multiple novations had occurred.

While processing OTC derivatives is undoubtedly complex there are aspects that can be automated to deliver greater control. Trade affirmation, trade allocations, reconciliation and novations are all areas that can benefit from investing in software and offer a quick win for the buy-side.

However, any technology deployed must offer an agnostic approach to data feeds and instruments. With the market developing at such a rate, the ability to take in new feeds and match on a sufficient number of fields is critical.

It should also support workflow through exceptions-based reporting and deliver operational dashboards for a clear overview of positions and outstanding items. Without intelligent business rules to correctly match

transaction data, for example, firms cannot deliver truly effective exception management, increasing both the cost and time to resolution.

Derivatives processing will become automated as firms realise there are standards in existence that can be used in conjunction with data agnostic and intelligent software to deliver greater risk and cost control. However, with outstanding confirmations still increasing at an

alarming rate – doubling between 2006 and 2007 – the automation debate is set to continue for many years to come.

Mark Taylor
SmartStream Technologies,
London, UK
E-mail: mark.taylor@smartstream-stp.com