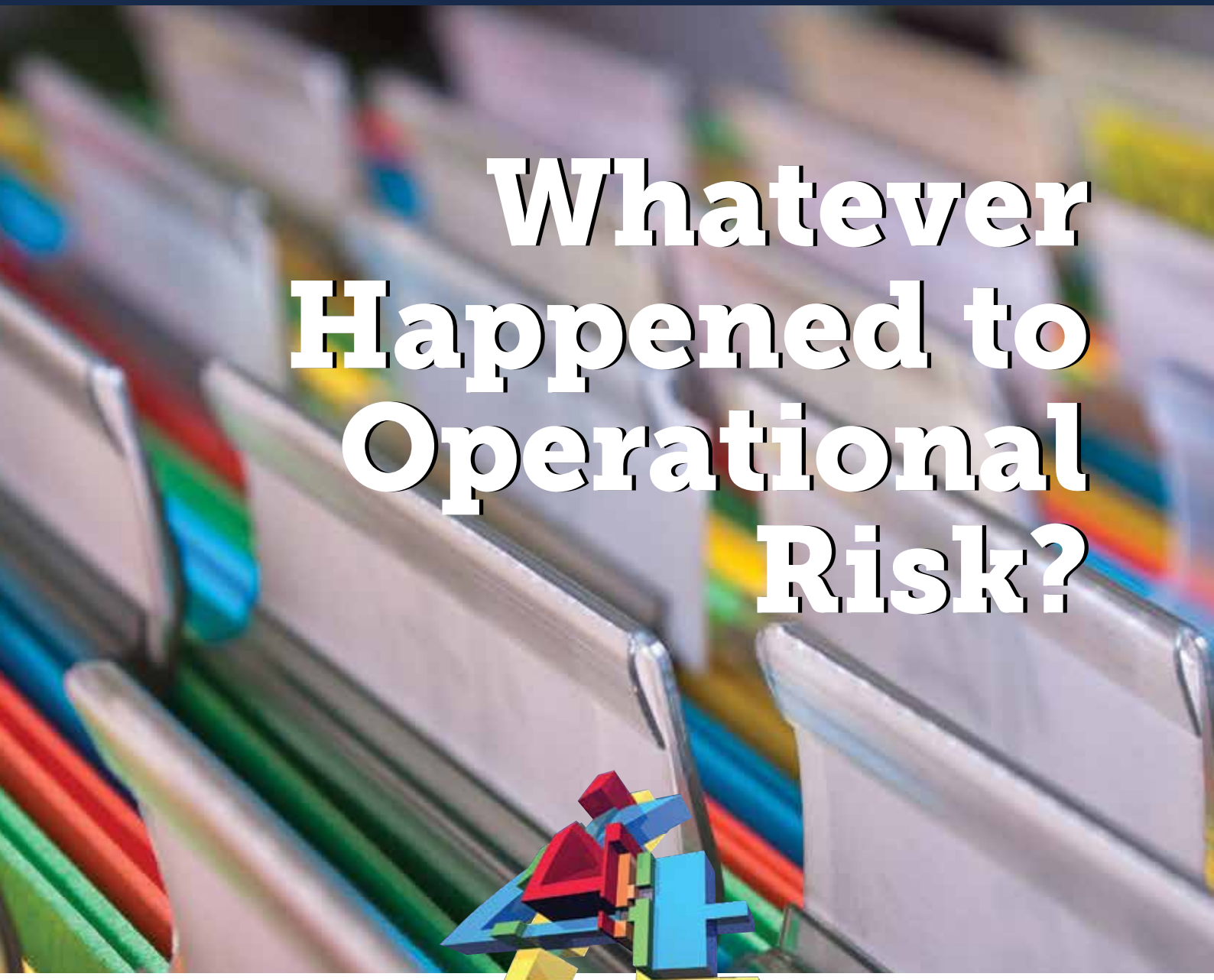
Securities Finance Monitor



Whatever Happened to Operational Risk?

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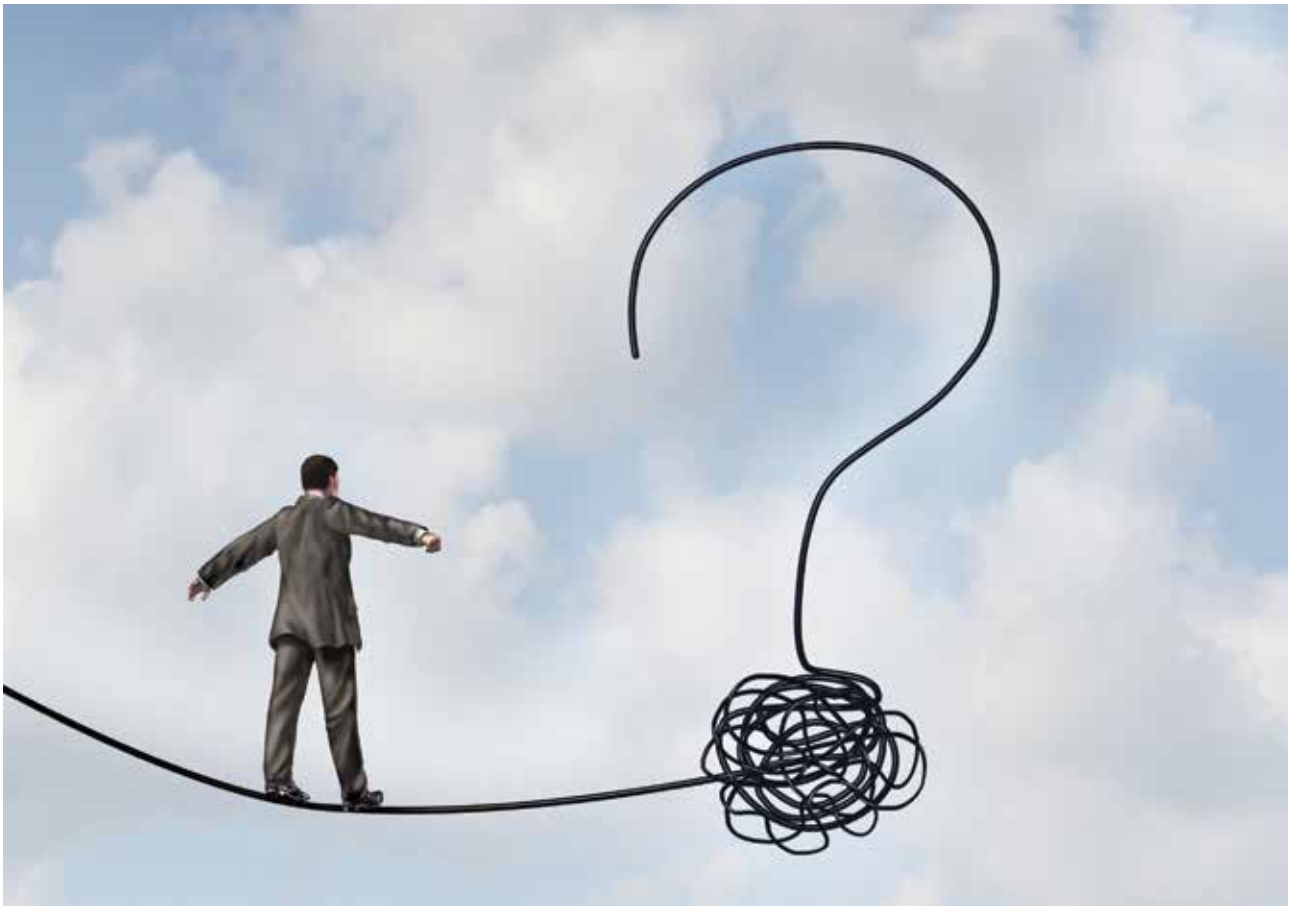

Whatever Happened to Operational Risk?

No one writes about operational risk anymore. Is it because it has gone away? Very doubtful. In the Securities Financing world, market participants have had other things to worry about, namely capital and liquidity rules that have forced re-thinking of business models. But operational risk is still out there and often goes hand-in-hand with the new regulations. Here are a couple of observations and lessons.

BY **ED COCKRAM AND JONATHAN COOPER, 4SIGHT FINANCIAL SOFTWARE**

Step One: Get rid of the spreadsheets. Whether it is calculating the total and incremental Risk Weighted Assets in a book of synthetic financing trades, tracking the Liquidity Coverage Ratio (LCR) impact of an evergreen repo, or understanding how Securities Finance Transactions net in order to report accurate Supplementary Leverage Ratio numbers or managing funding mismatches, all of these are absolutely necessary to run a modern financing book. Get them wrong – or any other metric -- and senior management won't be pleased.

What is the first step? Get rid of the spreadsheets. Industrializing the process for collecting the data paired with software to process and report the numbers is a huge advance.

Step Two: Frankenstein systems don't work. There is more to operational risk than reporting for new regulations. Systems that are bolted together over time, adding new functionality in a "Frankenstein" fashion, are hard to manage and painful to update. They are also expensive to run.

There is always that point when legacy systems may need to be fooled into accepting new types of transactions. We've seen a Total Return Swap (TRS) executed in a system that only understands repos. The books and records generated by such a trade may not be accurate without lots of manual massaging. That hands-on intervention is chock full of operational risk. Furthermore, managing a book of financing-driven TRS isolated from other financing businesses – often driven by systems constraints and/or historical organizational structure – shouldn't be anyone's idea of good risk management. This brings us to the second suggestion: manage similar risks together in the same systems and risk environment. We are looking at you: repos, securities lending and TRS.

Margin Management

Margin management is probably the purest form of operational risk. The darkest days of the financial crisis saw a mixture of large swings in exposures as markets lurched, trades were rapidly entered or closed, and exposures and the collateral margining them swung this way and that. Had the margin already been agreed, had it settled or was there a large exposure left uncovered? How was the deal performing, should there be fresh margining, were prices even updated for the deal or the collateral?

Bear in mind that these questions were not happening in a vacuum; tensions were running high both inside the firm and at the counterpart, with deadlines imminent. Secured market participants were swamped with urgent demands at the very moment they most needed to control for even the smallest of operational risks. Orderly markets and the processes used by participants began to break down.

Accurate pricing, and the resulting margin calls, was even more pronounced for illiquid paper. If a cash trader could not generate a reasonable bid/ask for paper, margining was little more than a shot in the dark. Using levels from pricing services to generate margin calls may give the appearance of good risk management, but there can be a liberal dose of "magical thinking" involved here when markets are stressed and markets are thin.

Automation, including better message interfaces, is a big help in tracking margin calls. But there is an undeniable element of judgment and interpretation too. A strong relationship between back, middle and front offices, including risk management, goes a long way toward controlling operational risk.

Smaller market players

Operational risk has been pushed down to those institutions with smaller financing footprints. G-SIB class institutions often got a head start by pouring enormous amounts of money into risk management and systems re-vamps. But many market players could not afford to invest while the rulebook was still a moving target. Some institutions with capital and balance sheet headroom (and aspiring to greater market share) have seen attractive opportunities emerge in the market vacuum. Others target creating or expanding new businesses that execute on an agency model, avoiding much of the balance sheet and capital constraints altogether. As market actors do what they do best – innovate – they need to keep on eye on robustly managing operational risks.

Collateral Crunch

The prospect of a collateral crunch one day will surely exacerbate operational risk. No, not tomorrow or maybe even in the next year or two. But as collateral demands stemming from non-cleared derivatives become the great "sucking sound" (apologies to Ross Perot) soaking up large quantities of High Quality Liquid Assets, Quantitative Easing assets unwind and with it LCR-eligible central bank reserves falling, and interest rates move high enough to make blind use of cash collateral seem a bad idea, the collateral equilibrium will shift. Knowing where your collateral is lodged will become more

important, as will making sure it travels to where it is needed as efficiently as possible. It won't take much volume to get to the point when the availability and best use of collateral (now generically known as collateral optimization) overwhelms spreadsheets (see Step One).

So what does this all mean for collateral managers?

Does this mean that collateral managers should be replaced by an all-singing system-based solution? Absolutely not. The change that is evident to a vendor across the secured finance space is that systems are being brought to bear in order to free up those responsible from manual tasks. Instead of manual tasks such as calculating an exposure, more strategic tasks, such as reviewing the trade capture and pricing process, become the collateral manager's norm. Time spent here pays dividends in ensuring that the firm is truly in the risk-return space it wants to be and that it's prepared for times of high stress in the financial markets.

Two key components of an automated and aggregated collateral management function are the inventory and exposure hubs. To be efficient, firms are looking to bring all of their group-wide global assets together into single systems. Combined with a global hub for exposures, firms can truly begin to optimize collateral. This produces a range of challenges in trying to consolidate such a disparate array of data feeds. While systems should alert users to errors in data feeds and reconciliatory breaks, collateral managers will need to be able to read the meaning into the breaks and identify temporary solutions whilst the fixes are implemented.

Similarly, while the best systems can model almost any collateral schedule and allocate collateral from the inventory hub, errors in interpretation will always occur. Collateral managers will doubtless spend a lot of time focused on honing the schedules, either on the contractual or system level. Then there are the analyses of collateral performance and assessment of the value in the various sources and sinks of collateral.

The more intuitive the system inputs and flows are, the less likely that there will be errors. This is where the look and feel of a system can make a big difference.

In conclusion, operational risk has definitely not gone away. Many of the market changes, many driven by changes in regulation, have made operational tasks more numerous and increasingly difficult to manage. Some of the old standards like margin management are exacerbated as cash markets lose liquidity. Good systems will help, but not without good judgment and a healthy respect for "garbage in, garbage out".

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