FORUM

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Electronic dealing – where will it take us?

Neil Cotter looks at how electronic dealing systems could evolve into on-line treasury systems.

The cost of acquiring information, both real-time and historic, is rapidly falling to zero. This factor, combined with the ubiquity of the internet and rapidly improving telecoms technology, means that it may soon be possible to develop a fully functional, on-line treasury system with 'friction free' business processes.

Wouldn't it be great, for example, if:

- you could transact financial instruments through your treasury system which was immediately and securely updated with the details of the transactions;
- your treasury system had continuous live rates for valuing your instruments and positions without the need to develop bespoke data interfaces;
- watertight security was in place to prevent corporate dealers transacting outside counterparty and overall limits;
- the FD could walk into an internet café in Taiwan and immediately determine the company's FX exposure (on reflection, maybe this isn't so great!);
- no software implementation was required for this system and it had excellent back-up processes and system reliability; and
- the treasury system to do all this was given away free of charge and was available to the smallest of companies.

Sounds unbelievable? Surprisingly, the technology and business proposition to do this are here today and have been for some time. The primary hurdle is that it requires banks to develop a collaborative system for offering and auctioning their financial instruments through the same electronic marketplace. Effectively, each bank will have a shop window in this electronic high street to advertise its wares together with the current prices. There is nothing new here – this kind of auction/purchase process is now starting for motor components, plastic, office consumables etc.

Today, banks are scrambling to hold competitive advantage over each other in the new dawn of electronic dealing. Each day another bank announces a sophisticated electronic dealing and information service which is creating a chaotic jumble of 'me too' product offerings for the busy corporate treasurer, but is this what the customer needs? The basic customer requirements are:

- simply transacted competitive dealing at the true market rate;
- simple efficient settlement;
- straight-through processing of transactions from execution to settlement; and
- minimal staff support to record, monitor and account for transactions within a defined level of control.

Neil Cotter

Does it therefore make sense for corporates to have a different electronic interface to each bank with their own quirks of access methods, security procedures etc? And how can a competitive trade be efficiently done through separate systems? Clearly a unified multi-bank interface is a better business to business model for the corporate treasury industry

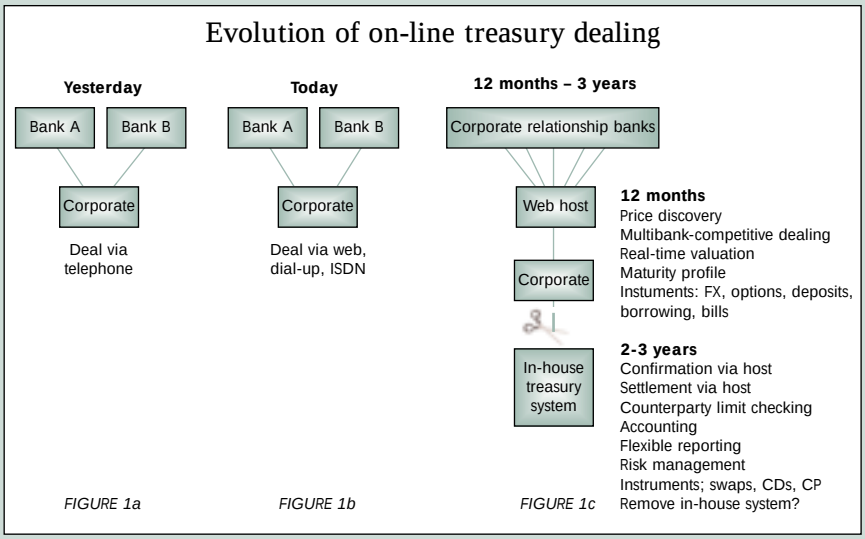
In the past few months some banks have recognised this as the future business model and joint ventures are battling to develop multi-bank solutions.

Whoever wins the war, it will be important that all counterparties can participate through these market dominant portals and I trust that the competition authorities will, in due course, ensure fair access to what will be tantamount to a public exchange.

Trading today – the reality

Typically, corporate treasuries transact financial instruments via the telephone (see *Figure 1a*), or some banks may provide the treasurer with an on-line dealing system (*Figure 1b*). Once the transaction is executed the treasurer will enter the details into his local treasury system. Confirmations will be produced and cross-checked by both sides upon receipt. All this activity is time consuming, prone to error and not particularly secure. Single bank on-line dealing systems will automate deal request and execution. They may also provide added value services such as real-time mark-to-market valuations, but these

FIGURE 1



services will only apply to transactions with that particular bank. This is only a minor evolution of the overall deal process since there are many other manual processes related to the deal.

Trading tomorrow – the promise

So what should we demand from a multi-bank platform ('the Platform')? Firstly, the corporate's current relationship bank should provide live pricing on request to the Platform through which the treasurer can conduct an instantaneous auction. The Platform should electronically provide transaction confirmations to both parties, monitor transactions and prevent counterparty limits being breached. The Platform should provide full audit trails, value the portfolio, identify and diarise deal maturities, assess value-at-risk, provide flexible reporting and account for the transactions. In other words, the Platform should be a true on-line treasury system so we don't need to buy and maintain one in the office. *Figure 2* identifies some of the key performance metrics which conceptually fit around 'the Deal' that is at the centre of treasury processing and control. Let's look at how performance against these metrics can be radically improved (see below and *Figure 3*).

Price discovery and transparency

Currently calling two banks at the same time to bid at the same instant is fiendishly difficult in a fast moving market. It is time consuming, and inevitably it is unlikely that the treasurer is getting the finest rate. Since the Platform can request bids from three, five or even 10 banks at the same time it gives the treasurer more chance of finding a bank with a natural short position which it wants to be rid of. Clearly this kind of tactic for large FX transactions or swaps may cause markets to move against the treasurer since it assumes infinite liquidity. Care and good judgement will always be required.

The simplicity of execution through the Platform is likely to encourage many treasurers to involve non-relationship banks in the auction process.

For banks there will be a significant challenge to the way they do business. They will find themselves up against many other banks on a competitive deal. Their communication systems with traders will need to be streamlined so that they can quote to instantaneous deadlines.

FIGURE 2

Deal confirmation

Currently, each bank has its own style of confirmation and sometimes they can take several days to arrive. It is usually only at this point that they can be verified. However, the Platform will be able to confirm all transactions with all counterparties on a single report on a daily or immediate basis to both bank and corporate treasurer.

Validation – dealer limits

The board or CFO needs to ensure that their treasurer is not a budding Nick Leeson who can breach counterparty limits or hide transactions. If the Platform knows the dealer limits by counterparty, and in aggregate it can stop transactions or provide immediate exception reports to the back office or CFO. Banks rarely enforce counterparty limits, thus it is often the company's internal treasury system which captures breaches post the event.

Deal valuation

Next we should demand that the Platform can value, and assess the risk of the portfolio with direct feeds of prices and correlation statistics at particular closing prices or real-time updates. Currently, live links between the in-house treasury system and, say, Reuters would need to be developed. The huge volume of data required makes this a challenging prospect which only the most sophisticated treasuries have implemented. The Platform makes this process much more efficient since it only has to invest in one link to allow all customers to update their transaction portfolios.

Settlement/counterparty risk

Eventually the Platform should be able to act as the conduit for settling transactions with each counterparty so it is acting as a clearing and paying agent. It will then be unnecessary to maintain counterparty details on both sides of the transaction. This greatly reduces the risk of funds being misapplied. Possibly the main corporate currency accounts could be maintained by the Platform making it unnecessary for physical transfers to take place. There seems no reason that given time and sufficient imagination the Platform could not become the treasurer's main banker.

Note: the counterparty risk (apart from settlement risk of the Platform) remains the same. Non-payment to the

Platform will still mean the exposure resides between the relevant counterparties.

Recording

It is not unusual for deals to be entered into in-house treasury systems incorrectly, opening up the risk of a company miscalculating its exposure. Also, the treasury systems may be unable to record unusual transactions which will then have to be recorded separately on a spreadsheet. This is highly unsatisfactory. The Platform, by definition, is totally deal-driven and should be able to record extremely complex transactions processed through it and therefore there should be no risk of human error or inability to record the deal.

On-line treasury

Next the Platform must diarise transactions, identify currency exposures, account for transactions and allow the treasurer to report on the treasury database via a simple query language. The Platform (*Figure 1c*) should now be able to fully replace the in-house treasury system for smaller operations. If this can be done the wins will be huge. For example:

- many smaller corporates operate their treasuries via spreadsheets: now they will have a sophisticated well controlled on-line treasury system at no cost;
- it will no longer be necessary to spend several £100k implementing and maintaining treasury systems;
- the transaction will not need to be re-entered into a system since it is captured at point of transaction; and
- the system will be able to be accessed from any PC without the need for software installation.

Chronology of development

Figure 1c gives a suggested chronology of how on-line treasury dealing may develop via Platform. The deal-driven front office elements will be the initial focus; followed by risk management and then finally back-office activities. The suggested timeline for all these activities to be automated is three years.

The downsides

The concept of the Platform does have some drawbacks. Firstly, transacting electronically can make the treasurer become more distant from the market since he no longer has direct contact with the dealers on market conditions. The banks have for some time had their own system, called EBS, for auctioning FX but often traders favour the voice box to stay close to the market. Secondly, if the Platform fails it has catastrophic implications. As well as being unable to trade it may prevent the treasurer from accessing the system for basic treasury reports. It will be a brave treasurer who switches fully on-line until there are well established market leading platforms. Finally, the Platform will need to be 'all things to all people': will the treasurer be satisfied with a Hobson's choice of a treasury system?

Looking to the future

Banks should plan for their multi-bank platforms to provide a total solution encompassing front and back-office processes surrounding 'the deal'. From doing the deal, auditing the deal, checking the deal limits , confirming the deal, valuing the deal, diarising the deal and so on.

The final result of the multi-bank platform will be the creation of huge, hopefully well regulated, global exchanges in OTC instruments. Corporates should demand that every aspect of the deal process be captured, controlled and reported so that local treasury systems, particularly for smaller corporates, are no longer required. There are huge efficiency and control benefits, but it is important that treasurers have a voice to shape the future. In particular it would be sensible that the various treasury bodies had board representation on some of the new platforms.

Looking ahead to the next five to 10 years, could the multi-bank platform become the clearing banker to the corporate? If it settles transactions as well then there will no longer be a requirement to initiate physical transfer since the relevant currency accounts can be debited/credited. The opportunities to create 'friction free' processes between the banker and the corporate treasurer are only limited by our imagination! ■

Neil Cotter is Group Treasurer of Logica plc. This is is an adaption of a speech given by Neil at the International Derivatives Conference in June.

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FIGURE 3

Metric	Competitive advantages of on-line treasury versus telephonic transactions
Price discovery	Corporates will have access to extensive live pricing from all its key central relationship banks.
Auction	Bids can be solicited and managed from many counterparties without additional staff overhead or transaction complexity.
Execution	Counterparties will be forced to quote against strict timelines ensuring transparency of best price. Corporate dealer time will be reduced. Activity will become almost clerical.
Validation	Platform can identify and prevent real-time breach of deal limits by counterparty and in aggregate
Netting/Settling	Platform can act as 'clearing agent' for all parties with all funds flowing through web host. No requirement to make payments direct to counterparties.
Confirmation	Confirmations instantly sent by web host electronically to both parties in standardised format.
Record	Simultaneous recording of transaction on on-line treasury system avoiding risk of re-keying error or data manipulation. Particularly helpful for complex products.
Account	High volume of customers will enable investment in significant accounting/reporting capability.
Monitor/Value	Platform will have real-time data feeds to value MTM positions with no risk of re-keying errors. No bespoke datafeeds required. Price targets can be set-up to initiate action.
Risk management	Real-time VAR datafeeds will be available. Real time sensitivity analysis likely to be built-in.
Accessibility	Full system access from mobile phones, palm held devices, TV etc.