Keeping track of FX deals – what cost control?

Clive Turner of City Networks argues the case for electronic trade confirmations in the corporate FX market.

The technical guidance notes included annually in *The Treasurers' Handbook* contain a section on 'Dealing procedures and the exchange of confirmations', the purpose of which is to 'assist members in their dealings in the financial markets' and 'illustrate the key control features that should be in place'. This guidance note summarises the recommended procedures and considerations for corporate treasury staff when dealing with counterparties in the financial markets, including dealer limits, division of front and back-office responsibilities, records of transactions and the exchange of confirmations. No doubt, all members of the Association are familiar with this document, but allow me to refresh your memory with the vital first and last sentences on 'dealing procedures'.

> 'Treasury procedures should be designed so that any error should be readily identified and quickly resolved'.
>
> 'A formal discrepancy reporting procedure should be established so that discrepancy investigations are properly controlled'.

In this article, we shall look at the most common of the typical corporate's dealings in the foreign exchange markets, in order to find out how closely these principles are being followed. We shall focus specifically on the failure or inability of many corporates to exchange and match FX trade confirmations with counterparties in a manner that meets the requirements of the Association's technical guidance.

Moreover, we shall look at the current market and technological developments that are now available to improve the existing situation.

Banks' use of STP for FX deals

The vast majority of foreign exchange transactions are performed between banks using secure interbank settlement and payment systems and communications networks. Although this process is not yet completely automated, the industry-wide push toward end-to-end straight-through-processing of transactions is providing significant impetus.

Banks' efforts are far from complete but the inter-bank FX dealing procedures contrast sharply with the growing non-interbank market for FX transactions: corporates now account for roughly 30% of overall volumes. Senior financial sector regulators regard unconfirmed deals or deals confirmed in a non-standard or non-formatted fashion in the non-interbank market as a threat to compromise the advances made by banks and other participants in the financial markets in adopting principles of straight-through-processing.

Control issues for treasurers

Dealings in the financial markets are the cause of one of the most difficult control issues faced by the treasury department. This is because the staff responsible for investment, foreign exchange and interest rate risk management will be given the opportunity by bank staff to use sophisticated products which inevitably involve an element of downside risk for the purchaser. Moreover, corporates require immediate execution of any transaction, be it an FX swap, a money market deal, or trading securities. Both historically and currently, this means allowing authorised staff to enter into a verbal but legally-binding agreement with the bank's dealer over the telephone. (Multilateral electronic trading over the internet may change this in due course, but may take considerable time if the migration to e-business platforms is as slow as that from paper-based forms).

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The nature of booking deals over the phone makes it impossible to impose any kind of security or control until after the transaction has been effected. However, best practice dictates that other staff in the corporate should be made aware of the details of the transaction as soon as possible after the transaction has taken place, preferably before any electronic funds transfer takes place.

A thorough procedures and controls manual is vital in order to segregate duties between the front and back office so that a dealer cannot settle or confirm a transaction, make explicit which members of staff have the authority to access the TMS and other related systems, and lay down procedures for two-way confirmation with the bank. It is also important to note that proper levels of control can only be exercised by members of staff outside the treasury, preferably in the accounts department, as 'Chinese walls' between front and back-office treasury staff may not be sufficiently robust.

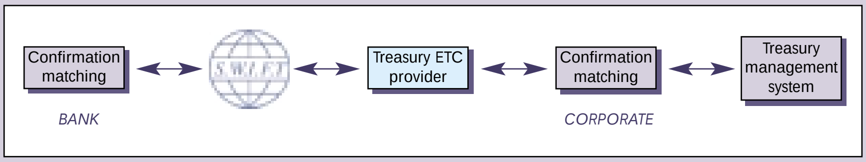
An immediate electronic exchange of confirmations between the parties should exercise the necessary level of control to ensure that any errors are highlighted in good time for them to be corrected before any significant impact is incurred.

More typically, however, this control function is fulfilled by a paper confirmation sent by the bank, by letter, fax or telex. In the case of postal confirmations, it may be anything up to four days before the accounts department is aware of a large transaction entered into by his/her colleagues in the dealing room. By this time the market may have moved considerably against the dealer, making it extremely difficult to correct an error in the original transaction. It is also worth noting that faxing or posting confirmation by the corporate invariably makes little difference to the speed at which any error may be corrected. Banks simply do not have a means of processing paper confirmations of FX deals from clients and will tend to assume that their confirmation is correct unless actively challenged by the client. This means that the onus is placed firmly on the corporate to ensure that the bank is informed of any discrepancy between records of the deal.

Some corporates consider the use of a restricted-access electronic funds transfer system to make payments to its banks, following FX transactions, addresses certain control aspects of FX dealing. Whilst errors or discrepancies with the bank's records will undoubtedly come to light as back-office staff check the FX transactions and forwards the requisite payments to the bank, this does not deal with the issue of the time elapsed since the deal was made. It may be several months before settlement of a forward contract is required, by which time the original paper confirmation may have been lost and no other confirmation matching control observed.

Although market volatility in major currencies is not significant at present, there have been sufficient sharp movements in the currencies of developing countries in the last two years to banish complacency. The ability to move swiftly to correct an erroneous trade – usually on a same-day basis – should be incentive enough to motivate treasurers to keep themselves up to date with ways of improving existing mechanisms and, in particular, the merits of using one of the electronic trade confirmation matching packages on the market.

FIGURE 1 **Confirmation matching via SWIFT**



Cost analysis of manual vs electronic confirmation matching

Inevitably, the motivation for any kind of change or upgrade to business processes and supporting systems must be justified on grounds of cost. And the fact that the cost of repairing unmatched or unconfirmed FX transactions is typically absorbed by the bank exerts significant inertia on corporates. This is despite the established presence in the market of two tailored confirmation matching solutions, which deal with spots, forwards and 'vanilla' options, for more than five years. The fact that direct cost benefits are unlikely to accrue from use of electronic confirmation of FX deals is reflected in the fact that some vendors make their confirmation matching software available to corporates free of charge via their banks.

Aside from the potential benefits of picking up dealing errors more quickly, a basic analysis of the administrative costs of physical matching of confirmations should make it clear that there are indirect cost savings to be made. Even if a company is making half a dozen deals a day, the time taken to mail confirmations to the bank, open letters of confirmation from the bank and match records generated by a treasury management system or spreadsheet can mount up very rapidly. In contrast, the time and effort required to check confirmations electronically is minimal as all the information is generated automatically, especially if the company already uses a treasury management system.

Moreover, corporates cannot expect banks to keep absorbing the cost of dealing with discrepancies between their paper confirmations and the queries of clients. One of the main drivers of the financial sector's drive toward straight-through-processing is the need to cut costs from back-office processes and offer an added-value service to customers. Clearly, sending out paper confirmations and fielding subsequent queries do not fit into this approach and it may not be too long before banks make electronic trade confirmation a prerequisite of any dealing agreement with corporate clients; and as multilateral electronic trading takes over from phone-based dealing, a new need for a dealing control mechanism arises. Any bank which is serious about offering a corporate FX dealing service is able to provide the necessary data and software to permit the user to match confirmations electronically on a daily basis.

New developments, new consensus?

Despite the control and cost issues discussed above, a relatively small number of companies use electronic confirmation-matching software at present, a stark contrast with its use in the financial sector. The recognition of mutual benefit that led to London brokerage houses funding the infrastructure AutoConfs service that has facilitated electronic trade confirmation amongst all market counterparties for some years is instructive here.

The recognition of the need to make better use of assets and infrastructure by industry organisations such as SWIFT is having benefits for the corporate market. As the volume of traffic across its messaging network decreases due to changes in the dynamics of the payments market, SWIFT has recognised the opportunity to facilitate different types of traffic – at the same time as addressing regulatory concerns on non-bank trade confirmations. Last year, SWIFT created two new categories of participant:

- **treasury counterparty** for larger corporates that wish to confirm their own trades directly using SWIFT; and
- **treasury ETC service provider** which allowed software firms to facilitator wide corporate access to SWIFT.

Although many still find the set-up costs prohibitive, limiting general corporates' direct access to the SWIFT network, SWIFT is working with partner firms such as City Networks to facilitate the transmission of electronic trade confirmations by a wide variety of corporates.

Previously, banks had to install specific software into their own systems as well as at the client site, in order to ensure that the data could be fed into the clients' systems. However, use of the SWIFT network via a treasury ETC service provider means that standard messages created by the banks can be fed into the FX confirmation matching software used by the corporate without any need for additional intervention *(See Figure 1)*.

So when a corporate sends an electronic confirmation of an FX transaction, the message will be automatically routed by SWIFT to the counterparty bank. Indeed, the only difference between an interbank confirmation and one which passes from the bank to the corporate is that the SWIFT code used to identify the corporate is derived from City Network's own code. Other similar services have relied on accessing SWIFT. via a single bank's link to the network, providing a batch processing-based, bureau-style service. But the new ETC category allows software vendors to offer a real-time FX confirmation matching service in which cut-off times do not apply and matching controls can be held at the corporate and/or the bank. The bank incurs a small annual administration fee as well as a per-item charge, but the corporate client incurs no charge and is only required to simply install software via a CD-ROM.

Food for thought

It is a sobering thought for the profession that for all the talk of using advanced technology to produce seamless treasury processes, many organisations with a high volume of FX deals do not use the most efficient software applications available. The result is that in-built control mechanisms and audit trails for financial market transactions are being overlooked. As treasury technology becomes more sophisticated, routine processes are increasingly automated and even outsourced: all the more reason for the appropriate controls to be put in place. Indeed, at a time when treasury departments, as well as the banks that supply them, are looking to cut costs and add value, a lack of automation and control is a potential barrier to outsourcing and further cost savings.

Regardless of such wider issues, treasurers know that the responsibility for control issues lays squarely on their shoulders and that auditors cannot be relied upon to uncover shortcomings in the proper control of treasury processes. Thus, a regular review of treasury procedures and controls in a fast-changing environment should include a thorough analysis of the solutions that current technological and market developments can provide. Failure to harness technology in order to exert control may not hit the bottom line immediately, but the prudent treasurer – like the car manufacturer that installs airbags and ABS brakes – knows that a secure and stable future requires a long-term approach. ■

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