

Chapter

1



**OPERATIONS
MANAGEMENT**

The management of operations in organisations within the financial services industry is a diverse challenge. The complexity of today's financial markets is reflected not only in the provision of the operational support and administration functions within major banks, fund management companies and brokers, but also in private investment, corporate business and the administering of the government in many countries. Trading and investment strategies become ever more innovative as new products are developed to hedge, speculate, arbitrage and invest. With each new product comes the need to administer the transaction, to clear and settle the trades so that the legal ownership is recorded and the relevant payments made. As the complexity of trading and investment increases so the demands on the operational teams that support the business grows. And, yet, it is wrong to assume that the sole function of an operations team is settlement.

Today there are many specialist functions within the overall operations remit. Client services, risk management, regulatory, profit generation and retention, and the marketing/sales of 'operations' products. The deregulation of many financial markets around the world has led to an explosion in transactions not in domestic products but in international products and markets. This move into cross-border trading is followed by cross-border settlement. The latter is infinitely more complex than the trading.

Through the 1970s, 1980s and early 1990s, the changes in the front office environment, particularly the growth

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of electronic and telephone dealing, growing international investment, the competitive environment created by the deregulation, the increase in the volumes of business and a growing need for greater regulation and protection for the private investor, all impacted significantly on the operations function. Dematerialised settlement saw less paper in the office, computer systems became central to the clearing and settlement process, international securities depositories reduced some of the problems and risk in settling cross-border trades. Industry bodies created guidelines for standard messaging formats, encouraged the use of uniform agreements and advocated facilities such as dematerialised (electronic book-entry non-paper settlement), rolling settlement instead of account settlement and stock lending and borrowing to help reduce the problems of settlement failing to happen on the due date.

However, the real catalyst for the dramatic change in the operations function came with the growth in the use of products like derivatives where an administrative error or the failure to pick up on a dealing error could result in six figure losses, and worse!

Ironically, derivatives were not exactly new instruments, their origins being back in the Middle Ages. What was new was the explosion in growth of financial derivatives, some relatively simple in concept like futures and options, others much more complex and bespoke.

It would be the combination of a dealer and derivative products that would ultimately bring about a complete

rethink on the importance of operations, but firms were also conscious of the need for greater technology to be available in the support areas to service the burgeoning business being created in trading and investment. There were also significant changes taking place in the markets themselves and particularly in the use of technology.

The London Stock Exchange (*LSE*) introduced the Talisman system and later CREST (after a debacle over another system, Taurus). The London International Financial Futures and Options Exchange (*LIFFE*) moved from open-outcry to electronic dealing through the LIFFE CONNECTTM system. LIFFE clears through the London Clearing House (*LCH*) its derivative products in what is now a completely electronic process, and both the London Metal Exchange and the International Petroleum Exchange, now part of the Intercontinental Exchange (*ICE*), also use LCH to clear their trades. (In late 2001 LIFFE announced it had accepted an offer from Euronext, the combined derivatives exchanges and bourses of Holland, Belgium and France, and in 2002 became part of that exchange. Subsequently, LCH and Euronext have discussed creating the largest pan-European clearing organisation by linking LCH with Clearnet, the Euronext clearing house.) In Germany the stock exchange and derivative exchange clearing have been merged into a single organisation, Clearstream, that also encompasses one of the first international central securities depositories, Cedel. Subsequently, Euroclear, another major international central securities depository, absorbed SICOVAM, the French depository, and through various shareholdings is closely linked into Clearnet and Euro-

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next. This means that there are two large groupings of exchanges, clearing houses and depositories in Europe and, as a result, the streamlining of the clearing and settlement process is rapidly occurring. Elsewhere, there are more developments such as the Nordic Alliance, Portugal's markets scheduled to be joining Euronext in 2002 and the LSE, having failed to persuade LIFFE to accept its offer, is talking in earnest with the US market, Nasdaq.

So much change is of course both creating short-term problems for operations teams, but generating longer term a more structured and simplified clearing and settlement process. To illustrate some of the slightly confusing situations that exist and will need to be resolved, we have:

- LCH, which is talking about linking into Euronext's Clearnet, is providing central counterparty clearing services to CREST for some LSE transactions; however, the LSE is talking about merging with Nasdaq having seemingly rejected linking to Euronext.
- LIFFE, which has become part of Euronext, is also linked to Nasdaq to trade share futures contracts via *Nasdaq LIFFE Markets* – the first US exchange to list share futures.

The process of rationalisation, links, alliances, takeovers (many exchanges are switching from being mutual memberships to publicly quoted companies) and mergers still has many possibilities and permutations to be played out.

Change is not confined to Europe. In the Far East the stock exchanges and derivative exchanges of both Singapore and Hong Kong have joined to create the Singapore Exchange (SGX) and Hong Kong Exchanges and Clearing (HKEx). In the US the big three derivative markets, the Chicago Board of Trade, Chicago Mercantile and Chicago Board Options Exchange have participated in a joint venture whilst the New York Mercantile Exchange has offered to buy the London Metal Exchange.

There is much more going on and changes will continue to happen around the world for some years to come.

Other influences on the role and structure of operations have occurred – in particular, the impact of this event that occurred in the derivatives market.

In 1995, Nick Leeson, a former back office employee who became a qualified derivatives dealer in the Singapore office of Baring's, changed forever the role and profile of operations.

In the aftermath of the collapse of the bank, it became clear that operations was not only a very critical means of risk control over front office activities, but it was also a major source of risk for a business in its own right.

The need to have independent verification of the trades, positions and financial movements associated with dealing was not simply administration and bookkeeping. Fundamentally, it is the key control, reconciling the actual market situation against the deal records and if

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it is inefficient, fails or is non-existent the whole business is put at risk.

Today this role is recognised and, thus, from perhaps a humble background, operations is now up there alongside the front office. In many of the more enlightened organisations there is mutual respect for the professionalism of their operations and a realisation that teamwork is not a cliché but a reality for a successful business.

So, the key factors that are changing the role of the operations team are the changes to the regulatory environment in the UK and elsewhere and the recognition of operational risk, as we mentioned earlier. On the one hand, we are looking at more professionalism and qualified personnel in operations teams and, on the other, a crucial role in the risk management of the business. Business skills as well as product knowledge are the requirements of managers and supervisors in today's globalised, diverse and ever expanding financial markets arena. The business skills are to manage budgets, personnel, risk management, and global trading and investment. Above all, the operations manager must be able to manage time and possess coaching and motivational skills. Product knowledge is to ensure that the increasingly integrated use of instruments, the development of systems and critical projects – such as straight through processing – can be managed successfully in the hurly-burly of daily routines.

To a business in the financial markets an inefficient operations function is pure risk. A top operations

manager is worth, and today is paid, a significant amount. So, they should be given the diversity of the role. Part business developer, part risk manager, part people manager and relationship manager to internal and external parties, the operations manager's time is unlikely to fall into the leisurely category. Even in 'quiet' market conditions operational functions continue uninterrupted.

Operations is still about routine and administration and record keeping, but today it is much more than this. For the operations manager it is a huge and demanding challenge and one that keeps growing as global financial markets come within the reach of all.

Box 1.1 Work session.

Significant changes have taken place in the industry and are still happening now. What are two significant ones that will or have impacted on your organisation?
