



# Extending Technology innovation to Tri-Party Credit Analysis



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*The nature of innovation is changing. In addition to technical skill and creativity, many innovations in financial services are now engineered with a deep understanding of business processes. For example, the automation of the tri-party give-up has reduced confirmation time from hours or days to real-time as banks have deployed new sophisticated networking and software products.*

However, the true innovation in this technology is not in its features and functions; rather, it is that the technology was designed and built to correct a business process that was inhibiting growth. The results are astonishing. By lowering the cost of trading through automation, the industry boosted the number of participants, the number of assets under management, the number of channels and consequently, generated huge growth in the number of trades.

## Defining the problem

Process innovations, like so many others originate with a problem. In the case of tri-party give-ups, the problem was how to make tri-party transactions more efficient by connecting the client, the prime broker and the executing bank in real-time.

Traditionally, executing banks involved in tri-party transactions faced major time delays. For example, a client may have ordered a trade and not received confirmation of the exact give-up price paid until the following day. This was due in large part to system incompatibility.

Furthermore, confirmations would be sent manually, which also introduced the possibility of human error. When summed up, all parties involved had an information gap that affected the ability to know their positions dynamically, which in turn reduced trading volumes. No longer so. Prime brokers, their clients and executing banks now have interoperable, always-on connections through innovative network services such as Hotspot FXi, Currenex Prime Brokerage and Traiana's Harmony service.

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These networks enable real-time monitoring and reporting of intra-day positions. All parties can now connect seamlessly using their own preferred method and format e.g. XML, Excel files in email, etc. All this combines to speed up the give-up process, enabling more trading volume.

### Lowering the psychological barriers

The power of timely, accessible and accurate information has the effect of lowering psychological barriers to entry for risk-averse institutions and lowering capital barriers to entry for newcomers because they can plug into those networks with less up-front technology investment. This confidence can be seen as banks swarm toward the hedge fund market, which alone accounted for more than \$12.7 billion in new money in the third quarter of 2005, according to data compiled by Tremont Capital Management.

As processes improve, innovation spreads to other processes and across to other asset classes. For example, innovations in the tri-party give-up process are now being extended to credit analysis. Previously, a manual calculation would have been made following the give-up to determine whether the prime broker was trading within the credit limit in the tri-party agreement.

Internal control systems were costly, slow and prone to error. Now it is possible to centralize credit calculations, through similar process automation platforms and networks, so they are done as the transaction is occurring. This function gives the prime broker and the executing bank an accurate credit position in real-time. Executing banks can also set limits and create rule-based alerts that help manage risk more proactively.

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### Importance of Hedge Funds

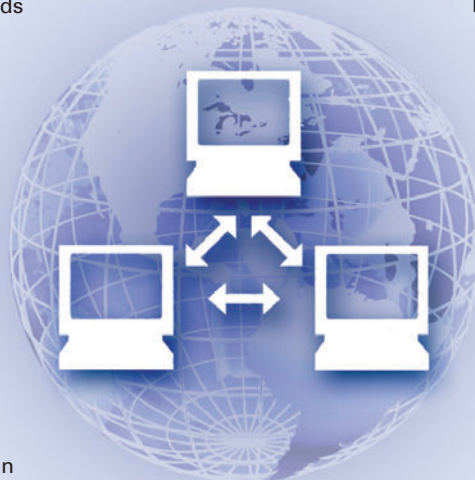
The automation of the credit analysis process has resulted in increased confidence from the large financial services institutions to expand their business to include more aggressive investors. Banks want more hedge fund business, but they want to be able to calculate risk with immediacy.

Hedge funds, in fact, are in many ways driving financial services technology innovation and investment. At a recent Wharton Finance Conference, Dow Kim, Merrill Lynch executive vice president and president of global markets and investment banking, noted that 8,500 hedge fund managers control \$1

trillion in assets. In a TowerGroup research paper entitled ‘The Changing World of Hedge Fund Managers, analyst Matthew Nelson estimates that hedge fund administrators alone will spend \$250 million on technology by 2008. Much of this will be invested in their trading platforms.

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Hedge funds increasingly view foreign exchange as an attractive asset class. According to the Bank for International Settlements Survey 2004, FX turnover rose from \$1.38 trillion to \$1.88 trillion, from 2001 to 2004, with hedge fund trading playing an important role and is forecast to expand to \$3.0 trillion by 2008.



This high level of interest is an obvious opportunity for foreign exchange prime brokers. Once relegated to a small, dark corner of the trading floor, they are now investing in automation technology to take a lead position in differentiating themselves and moving up the value chain in client service. Real-time tri-party credit analysis is crucial here because it enables brokers and executing banks to make better decisions more quickly. The ability to plug into a network reduces time-to-market and investment in additional resources. Industry analyst Dushyant Shahrawat writes in his report ‘Stocks, Bonds, and Currencies: Analyzing Automation of Capital Markets Across Products’ that automation moved from equities to bonds to foreign exchange, and each asset class has automated different processes to different degrees.

One can see how innovation can spread to different parts of a single industry. Indeed, 38% of financial services respondents in a survey done by The Economist Intelligence Unit (2005) declared that technology innovation would have the greatest impact on their company’s business model between 2005 and 2010.

### Collaboration

Innovation, it should be noted, also comes from collaboration. Institutions like ABN AMRO, BNP Paribas, HSBC and JPMorgan Chase increasingly work with technology vendors to define and agree on how technology can help define and address basic process elements that would benefit everyone in the trading universe. Their active engagement is vital and as they continue to work with the technology industry to examine and improve their processes, they will find ways to apply technology to make better decisions, which will increase growth and profitability.