Modernizing Derivatives Oversight Through Accounting Optimization

Historical inefficiencies in accounting software made accounting workarounds for complex products a matter of necessity. As vendor offerings have caught up to this complexity, is your firm prepared to migrate these assets between platforms?

It has been said that a job can be done well, quickly, or cheaply and we're lucky if we're able to pick two of those for the same job. With limited resources and a fast-paced environment, notably in back office, speed is frequently prioritized above all else resulting in bulky, convoluted workarounds for complex issues.

Accounting modernization can:

- Reduce key person risk and maintenance of customized tools
- Stabilize operations by enabling straight through processing
- Ensure accessibility of detailed historical records
- Enable processing of more complex derivative types
- More easily enable changes from regulation such as LIBOR retirement
- Give greater transparency to asset valuation and performance drivers

To cope with limitations of the legacy accounting system, external workarounds are often implemented to solve for deficiencies. Frequently, these workarounds are utilized to accommodate complex products like derivatives. These processes often rely on experts for maintenance and are typically built around Microsoft Office products such as Access and Excel, frequently closing the gaps through more customized code in visual basic. This represents significant key person risk to the firm when individuals who build and maintain these processes move on to other roles.

Fully processing these complex assets in the common book of record eliminates this risk by standardizing the process and enabling greater oversight. Several vendor offerings can further improve oversight and processing of these assets by handling life cycle management, automatic settlement of cashflows, and enabling straight through processing.

One of the challenges in older accounting systems or out of date versions is the security master set up for more complex products is often convoluted at best or completely unsupported. One of the simplest workarounds for this common issue is to create a generic unrealized and realized entry under a dummy CUSIP to capture the daily variation margin for these products. Not only does this limit the ability to see detailed transaction information, but it may also lead to gradual deviation between actual and recorded realized and unrealized gains and losses. Small differences in daily valuations can add up over time and accumulate due to limitations in significant digits for price or FX values. When these seemingly minimal differences are combined with leverage products, the deviation becomes more significant and more difficult to account for over a longer period. This difference is difficult to explain without independently verifying the realized gain or loss for each individual trade and may necessitate the firm notifying and reimbursing clients depending on the impact. While this detailed reconciliation process may be tedious, it's necessary to re-align for accuracy and to determine materiality.

In my latest article about maximizing performance through proper collateral management, I explain how the right platform can enable higher-level automation and reduce risk and headcount. This level of upstream automation is very difficult to achieve if manual workarounds in the back office are disrupting the flow of straight through processing.

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For example, during quarterly resets for credit default swaps, individual payments and receipts may have difficulty netting as the individual SWIFT references cannot be applied to a lump sum entry on an automated basis. Beyond not receiving the full benefit, the back office may find themselves in a more difficult position as these products scale upstream of their workarounds, compounding current pain points. This is especially problematic in the face of a large-scale change driven by external factors such as LIBOR retirement which may necessitate larger rolled trades to exit outdated rates. The volume can become unsustainable with the current workarounds, leading to impactful processing errors.

Back and middle office workarounds can be difficult to unwind. Many accounting systems in use often already have the necessary functionality on newer versions, but several leading vendors do as well if other factors require implementing a new vendor. Enabling this functionality not only eliminates the need for homegrown applications to manage assets outside of accounting and investment books of record, they can also enhance the process beyond the current operating model, provide the broader firm better access to information, and enable better oversight while reducing risk.

HOW MERADIA CAN HELP

Meradia has the experience and expertise to help enable existing functionality, vendor selection, and the historical remediation often necessary to onboard processes developed as a workaround. Meradia knows the challenges firms face with properly listing complex products in accounting and investment books of record.

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