Creating Efficiencies and Reducing Operational Risk with an Investment Book of Record

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An increasingly critical middle office function is delivering accurate and timely position data to the front office and ensuring redundancy with outsourced back-office services. This article discusses the operational, regulatory and competitive drivers for automated position management facilitated by the Investment Book of Record (IBOR). While the IBOR has become mainstream technology for buy-side firms, its importance and utility to both the front and back office continues to grow.

Position Management Challenges

Development of the IBOR was driven by the realization that back-office systems were not designed with front-office needs top of mind. Maintaining an accurate and up to date view of positions, cash and exposures is key to the successful operation of an investment firm, yet one of the most difficult processes to implement successfully. Back-office systems inherently suffer from a number of significant limitations in their ability to deliver accurate position data to traders and portfolio managers:

TIMELINESS: Portfolio managers require continuously updated intraday views of cash and positions. This can't be obtained from back-office systems reliant on overnight batch processing.

MULTI-ASSET SUPPORT: Many back-office systems lack broad asset class support and the flexibility to implement new instruments and asset classes. One example is the growing popularity of bank loans in institutional portfolios, requiring the ability to process daily pay downs.

ACCOUNTING-CENTRIC: Because they primarily serve investor and regulatory requirements, back-office systems maintain an accounting-centric view of cash and positions, which is based on settlement date rather than trade date. While certain corporate action events are processed on a settlement basis, a portfolio manager needs to understand trade date impact. This requires an investment-centric orientation toward position data.

AGILITY: Especially with outsourced back-office systems, new account creation may take days, resulting in unwelcome delays when new clients or portfolio managers want to invest funds immediately.

TRANSPARENCY: While back-office outsourcing provides benefits for many investment firms, it also limits transparency. Firms can see their positions start-of-day, but lack visibility into the underlying transactions, reference data and other key details. This forces firms to manually validate positions and transactions using spreadsheets or proprietary tools.

> **"Over 50% of buy-side firms surveyed by TABB said that they experience trade errors, mainly caused by incorrect position or cash data across separate front-, middle- and back-office systems"**
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> **Source: TABB Forum**

These limitations have tangible and potentially significant impacts on investment firms, resulting in over/under investment due to inaccurate cash forecasts, improperly hedged positions, suboptimal use of scarce collateral and costly operational errors and compliance breaches.

Automated Position Management with IBOR

At a fundamental level, the IBOR ingests and aggregates data from multiple sources, including internal and outsourced accounting systems, order management systems, reference, pricing and corporate actions providers, and cash inflows and redemptions. A properly designed IBOR automates position management, providing the front and middle office with an accurate, real-time, and consolidated view of positions and cash. As an independent source of start-of-day positions, IBOR decouples the front office from the back office and enables consistent management of position data. This also provides firms with an alternative to outsourcing their back office; or, for those committed to outsourcing, it serves to validate that service.

An effective IBOR solution reconciles positions against back-office accounting systems, fund administrators, and custodians and supports exception-based workflows driven by user-specified matching rules and tolerances. Users should have the ability to determine the scope of each reconciliation – running across all positions, or a set of positions, at specified times to prepare for next-day trading in different regions. Given that IBOR sits at the intersection of multiple internal investment systems and external service providers, support for APIs and industry standard messaging formats is a key technology requirement.

This provides investment firms with increased competitive advantage, greater regulatory responsiveness and improved operational efficiency.

Competitive Advantage

With margin pressure eroding active manager's profits, firms are focused on minimizing unwanted risk and providing their front office with the data and analytics required to make informed trading and investment decisions. Passively managed funds also require up to date information on investable cash, and leveraged funds need to track derivative exposures and collateral.

An IBOR must support all of these requirements, and allow portfolio managers to model the impact of projected cash flows and corporate actions on their portfolios. From a productivity standpoint, IBOR can eliminate manual, spreadsheet-based position aggregation, freeing managers to focus on higher value activities.

Regulatory Responsiveness

Several regulatory drivers support the need for automated position management, especially for firms operating in multiple regulatory jurisdictions. Seemingly disparate regulations like Solvency II for insurers and Dodd-Frank for investment managers both require accurate and up to date views of exposures across counterparties and underlying derivatives.

The SEC's looming implementation of Form N-PORT will require investment firms to report their portfolio holdings on a position-by-position basis. Encompassing nearly 600 data points, the regulation imposes a significant new reporting burden on investment managers. These include country, risk and industry categorization for each holding, derivative counterparties, and portfolio- and position-level liquidity and risk measures.

Extracting and integrating this information from disparate accounting and portfolio management systems using spreadsheets is neither effective nor viable. In addition to supporting new middle office workflows for meeting these regulations, an IBOR can also enable reconstruction of historical positions and transactions, allowing firms to respond faster to regulatory inquiries.

Operational drivers

Years of buy-side cost-cutting and downsizing have placed a greater demand on automation and system consolidation to support a firm's investment process. By automating position management, an IBOR can provide a number of important operational benefits:

> "Having an IBOR is not the goal. The goal is the delivery of accurate information to business users throughout the day, such that they can make the best possible decisions based on that data."
>
> Hugh Griffiths
> Managing Director
> CutterConsulting

FASTER RECONCILIATION: The industry trend toward expedited reconciliation is critical to reducing operational risk. Firms with trading desks across multiple time zones and geographies require fast and configurable reconciliation before "walking the book". Exception-based reconciliation streamlines the end of day close by flagging problematic positions quickly, letting the front office focus on resolving exceptions instead of manual reconciliation.

PORTFOLIO COMPLEXITY: As firms employ increasingly sophisticated multi-asset strategies and greater use of derivatives, position and cash management processes also grow in complexity. IBOR must support all asset classes, providing valuations for each position based on the latest pricing data and analytics. For OTC derivatives, IBOR requires the ability to process and project cash flow payments, including asset- and mortgage-backed security pay-downs and swap cash flows.

SYSTEM CONSOLIDATION: An IBOR can provide firms with significant opportunities for system consolidation. Asset class-specific legacy systems and point solutions can be retired, minimizing resource bottlenecks and support requirements. A streamlined enterprise architecture also reduces the number of potential integration failure points.

REDUNDANCY & FLEXIBILITY: Large and mid-tier firms deal with multiple back-office outsourcing services and potentially dozens of custodians. This introduces inefficiencies and operational risk. An IBOR serves as a single repository for position data and maintains an independent view of positions. This provides firms with flexibility when service providers are hired and fired, or currently outsourced accounting functions are brought back in house.

Providing a data-driven foundation for growth

The Investment Book of Record has become a central and indispensable component of buy-side technology stacks. Both new and existing regulations make it imperative for firms to have transparency into their current positions and exposures, and require the ability to reconstruct historic positions on demand. Supporting asset growth and client retention forces firms to offer new products and expand into new geographies, requiring a solid, data-driven foundation to service that expansion. An IBOR provides that foundation across all asset classes and geographies, enabling firms to focus scarce resources on their target operating model supported by a single, consistent, and up to date view of positions and exposures.

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