

Operational view



Rupert Perry, co-founder of Pirum Systems, explains the workings and necessity of contract compare and brings together common industry feedback

What's the point of Automated Contract Compare?

Running automated Contract Compare for all open positions and actively reviewing the resulting breaks every day is recommended as a “Best Practice” by both The International Securities Lending Association (ISLA) and The Risk Management Association (RMA). The key benefit it provides is a daily verification that the core books and records for open stock lending / repo transactions are accurate and complete. This mitigates the plethora of risks associated with incorrect positions and significantly reduces the time spent investigating break issues in downstream processes.

We're too busy to look at contract compare...

When operations teams get busy or staff turnover is high, contract compare is often one of the first operational processes to suffer. Whilst in the short term, a reconciliation not done today can always be picked up tomorrow, if work pressures remain over an extended period, tomorrow soon becomes next week, then next month and before long, breaks may not have been reviewed or investigated for several months.

Accurate data is the foundation for the smooth running of almost all other post-trade operational processes, so when data integrity cannot be assured, exceptions in the exposure, marks, returns, monthly billing, and dividend/ coupon claims processes will often cause much more time to be spent in these areas than normal. There is no doubt that dedicating time to clearing contract compare breaks actually saves significant time and effort overall given a holistic view of all post trade processes.

For example, the correct calculation of dividend/ coupon claims requires accurate positions and matching dividend rates. When positions and dividend rates have not been agreed with the counterparty, any undetected differences will delay the payment of claims and has the potential to cause significant funding costs to Lenders who have a contractual requirement to pay dividend claims to beneficial owners on the dividend pay date. Often these breaks are much harder to resolve once a claim has been issued, as the underlying error may have occurred some months earlier.

When fee and rebate rates or positions are mismatched, the resulting billing difference at month-end will often cause payment of the bill to be delayed (sometime by many months), whilst the source of each discrepancy is investigated. Furthermore, internal P&L reporting will probably then be inaccurate and may require significant adjustments to

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be posted after month-end.

Automated contract compare is also a very useful way of ensuring that your counterparty has accurate books and records too. Even when it turns out that your own records are accurate, you may need to expend significant operational effort proving the accuracy of your data if your counterparty thinks otherwise.

But we reconcile our positions manually...

Whilst it is possible to reconcile stock lending transactions by hand, it's a very time consuming process (unless there are only a handful of trades open) and it's uneconomic to do this on a daily basis. As a consequence of infrequent reconciliation, breaks tend to be numerous and differences will often remain undetected for significant periods of time causing increased operational friction. Manual reconciliation also lacks the common workflow for communicating, clearing and assigning breaks that an automated comparison tool provides.

But we reconcile our depot positions with our custodian...

A depot reconciliation with the custodian is a useful control, but it does not provide much assurance about the accuracy of stock loan transactions in your books and records system. For example, trades may be booked with the wrong counterparty or with incorrect fee, rebate or dividend rates without causing a depot break.

But we compare our billing statements each month...

Unfortunately a billing reconciliation on its own cannot verify the accuracy and completeness of all positions,

because collateral pledges (other than pool cash) do not appear on the billing statement and contractual elements of the trades which do not affect billing are not shown and cannot therefore be verified (e.g. dividend rates and term dates).

Another key issue with relying on billing reconciliations alone is that discrepancies will rarely be identified on a timely basis, as billing by its nature is always looking a month behind. The timeliness issue also has a tendency to make the breaks harder to fix, as traders can more readily recall what was agreed when a break is identified promptly than they do if it isn't brought to their attention for some weeks or months. *