

Focus On Derivatives In Fund Management

The Bank of New York Mellon's perspective

Caging the beast: OTC derivatives and counterparty risk

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Today it is universally acknowledged that over-the-counter (OTC) derivatives present money managers with a number of distinct advantages over traditional investment products, not least cost efficient hedging and the ability to tailor an instrument to a fund's precise requirements. Unfortunately, as is also widely recognised, they do carry an array of risks.

In the context of the global financial crisis, one of the most pressing concerns for investors, banks, insurance companies, funds and other derivative users is counterparty risk – the possibility that one party in a bilateral transaction will fail to fulfil its contractual obligations over the life of a transaction. This risk is prevalent in OTC derivative trades but is not easily addressed in practical terms. Identifying the risks upfront and implementing a robust operational capability to manage those risks are critical in the utilisation of OTC derivatives.

From governance through to reporting, counterparty risk needs to be monitored throughout their entire existence in order to adequately manage and mitigate the risks as far as is possible. It is critical that the relevant information for mitigating these risks is available to everyone involved, from front office sales desks, to collateral management staff and to administrative clerks. Doing this can be infrastructurally – and hence cost and resource – intensive, but in the emerging, post-Lehman world it cannot be viewed as anything but a sound investment.

Risk mitigation around these instruments falls into two broad categories: pre and post execution.

Pre-trade

First and foremost, the credit-worthiness of any counterparty to an OTC trade needs to be vetted and, as far as possible, understood. Ratings can be used as a guide, although they are by no means the only barometer that should be relied upon.

In addition to ensuring that the chosen counterparty is creditworthy, it is also prudent to transact with more than just two or three counterparties – this spreads (and hence reduces) the risk of any default across a higher number market participants. A strong governance structure therefore needs to be put in place to ensure robust counterparty selection procedures followed by ongoing monitoring/evaluation.

Once creditworthy counterparties have been identified, and the optimal number agreed upon, the next key step in mitigating counterparty risk takes place during the contract negotiations.

There are certain features that can be variously included or excluded from a standard ISDA master agreement – for instance, mutual "right-to-break" or "credit put" clauses. These are clauses within the structure of any particular OTC transaction, whereby either party can break a deal at the mid-market rate using an agreed source; in essence, the derivatives user can effectively shorten the life of their credit exposure by deploying these puts either every year or five years into the life of long-dated deals (which can extend out as far as 50 years and beyond).

In addition to specific features within the ISDA agreements, buy-side firms should also negotiate Credit Support Annex (CSA) agreements with their counterparties. A CSA agreement defines the rules relating to the posting of collateral to counterparties, including acceptable instruments, timings of margin calls, thresholds, minimum transfer amounts and mechanisms for managing mark-to-market disputes.

Last but not least, another tool that can be used prior to trade execution is the posting of initial margin – something that has become very common for hedge funds and other entities whose creditworthiness is not immediately clear, and which can be utilised by either party depending on the respective credit status of each organisation. The level of initial margin is typically determined at the outset of each transaction and is agreed upon based on the size, tenor and volatility of the underlying instrument or security. This initial margin serves to protect the receiving counterparty against movements that occur before collateral can be posted under the CSA.

Post-trade

Even once a trade has been executed with a chosen counterparty, there are still avenues open to buy-side institutions to limit undesirable exposure. For example, it is possible to unwind existing contracts with one counterparty by bidding out the contracts to other counterparties. The other counterparties do not need to have lodged documentation with the buy-side institution, only with the dealer with whom the buy-side institution has the original deal, making the transaction immediately more marketable.

Another post-trade technique for reducing counterparty exposure is intermediation, whereby a second, more creditworthy counterparty stands between the two parties to the original transaction for a fee. This mechanism reduces the undesirable exposure while keeping the original structure in place.

For those institutions trading a variety of OTC instruments, it is possible to balance opposite-way trades with existing counterparties so that the net mark-to-market (MTM) on any specific portfolio does not get too large with that particular dealer. This is beneficial to both parties to the trade, and serves as an easily-deployable tool if there is a robust operational infrastructure supporting the trades.

The operational context

As suggested above, there exist a number of operational risks for buy-side institutions in terms of managing counterparty exposure, and it is pertinent to mention these operational concerns in any discussion of counterparty risk mitigation. The execution of OTC transactions is often confirmed verbally, so electronic confirmation of contracts is vitally important to understanding any exposure.

Advancements in automated matching and confirmation – notably on the part of the Depository Trust & Clearing Corporation (DTCC) and MarktWire – have certainly reduced the number of unconfirmed trades. But not every type of OTC

transaction can be confirmed in this fashion: for those products, it is vital that both counterparties fully understand the economic terms of the trades if the product is to be properly valued and the magnitude and direction of any future exposure understood. Accordingly, capturing the correct datasets at the very outset is of critical importance.

Obtaining independent valuations for OTC positions is becoming ever more essential for auditors and regulators alike. When it comes to managing counterparty exposure, it is no longer satisfactory merely to accept without question a counterparty's valuation, as that eliminates a key control within the operational process. If products are set up incorrectly, they will necessarily be priced differently by both parties to the transaction and will accrue income at different rates. It is vital that such discrepancies are detected and corrected at the earliest opportunity.

Another operational issue that buy-side firms must address is the reconciliation of OTC positions against counterparties. This has typically been performed during the collateral management process, however this is not a watertight approach – positions are only ever checked if there is a difference in exposure to a particular counterparty that breaches a pre-agreed tolerance. A complete daily or weekly reconciliation will ensure that trade records are accurate, and this is something that the largest market counterparties have agreed to move towards in a concerted fashion.

Finally, the operational management of collateral agreements is plays a central role in the mitigation of counterparty exposure. CSAs can be complicated and difficult to digest and implement in an operational context without additional investment in infrastructure and training.

In addition, as the number of counterparties expands, and the collateral agreements themselves increase in complexity, so the operational requirements of managing those agreements becomes more onerous. Given that collateral is one of the most important tools for managing counterparty exposure, a failure to invest in the required operating processes could prove a costly mistake.

A holistic approach

In conclusion, the plain truth is that counterparty risk is inevitable – but, crucially, it is also controllable, if managed within the correct environment. In order to manage the risks mentioned above, ensuring that the relevant in-house teams have access to accurate information in a timely manner is of the essence. An integrated suite of products – such as The Bank of New York Mellon's *Derivatives360* offering – which spans trading and execution services through collateral management to operational outsourcing can help money managers control their perceived risks. Similarly, partnering with a third-party provider that can act as a market counterparty to your trades, to manage your collateral and to manage your operations, providing you with the granular information required to manage and mitigate these risks.

