

The Exhausting Challenges of Managing Counterparty Risk

➤ **BY TIM LIND, MANAGING DIRECTOR,
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As financial institutions search for answers to our current crisis, it is natural to be introspective about our business model, our core values, and the future of our industry. It was a shock to everyone in this business how quickly operational risk and market risk could lead to systemic risk. If there is a silver lining to this recession, it may come in the form of a commitment to address long-standing gaps in our infrastructure and governance. As part of this process, institutions are undertaking a rigorous assessment of all their business risks, including market, counterparty, credit, liquidity, legal and operational risk. Valuation risks associated with structured products and non-vanilla, over-the-counter (OTC) derivatives are clearly going to be a big focus from here on, but firms are also focusing intensely on the reduction of counterparty risk. High-profile credit failures, such as that of Lehman Brothers and the government of Iceland, coupled with the complexity of OTC instruments, have made counterparty risk a daily concern for market participants. A recent Wall Street Journal “Future of Finance” article cited “enhancing collateral” as one of their top 20 principles for rebuilding the financial system.

The bilateral nature of the OTC markets, combined with the lack of a central counterparty, offers plenty of opportunities for risk to infiltrate transactions. To mitigate this risk, a growing proportion of OTC derivative transactions are being collateralized. In fact, the International Swaps and Derivatives Association’s most recent figures estimate that \$2.1 trillion of collateral, consisting mainly of cash and government securities, was placed as security across 149,000 collateral agreements at the end of 2007. It has also been reported that the percentage of positions covered by collateral has increased significantly to 63 percent, more than double the figure for 2003. Additionally, there are now day-to-day operational activities required to manage open transactions in the millions and executed agreements in the tens of thousands.

MANAGING RISK EXPOSURE

The ability to keep firms not only at arm’s length from the ravaging effects of realized credit risks, but also permit them to continue trading during times of extreme market volatility with counterparties of varying credit-worthiness, is a critical factor to successful and responsible trading in derivatives, whether exchanged-traded or OTC. It also happens to be one of the most practical, efficient methods of reducing counterparty and credit risk, and is equally applicable to sell-side and buy-side firms.

However, managing this amount of exposure and mitigating collateral risks pose massive operational challenges, since in one way or another, collateralization becomes predominantly an “operational risk” management exercise: a highly procedural, middle-office activity involving the simultaneous handling of a large number of ancillary/transferred risks. Many of these risks revolve around both electronic and human interactions with other parts of a firm’s business, internal sources of data, trade counterparties, other third-parties and external systems. The task of collateral operations is therefore to identify, monitor, and manage these risks as efficiently and as completely as possible. No easy feat, for certain.

COLLATING DATA

The first hurdle is that collateralization, even in the smallest organization, depends overwhelmingly on volumes of time-critical, location-specific data from outside the organizations’ boundaries, some of it from third-party

providers. Transactions, collateral balances, corporate data, market data, static data—the list is long (and potentially extensive, depending on requirements)—all need to be consumed and collated on a daily or intra-day basis in order to calculate latest margin requirements. Issues of delivery, timeliness, quality and quantity become key to enabling collateral managers to meet their deadlines. In fact, due to the internal dislocations in some firms’ data delivery mechanisms, publishing margin calls on deadline can be virtually impossible. Even after they’ve been published, the collateral manager’s job is only partly done.

ALLOCATING DATA

Second, collated data needs to be allocated to portfolios according to the terms agreed upon between the parties which are found in master agreements and credit support documents. These terms can number in the hundreds, can be driven by credit ratings or net asset values, and often need to be both market and jurisdiction-aware. The terms also need to support the algorithms for calculating latest margin calls, which tend to be product specific and can involve nuances. These may include haircuts (the percentage by which an asset’s market value is reduced for the purpose of calculating collateral levels), the conditional minimum transfer amounts and rounding increments in order to arrive at actual margin obligations.

Failure to record these terms completely and accurately can easily lead to incomplete, inaccurate portfolios, and can also result in erroneous calculations and inexact margin calls. Inevitably, in these circumstances, disputes with counterparties will arise, which could further delay or even prevent the receipt of required collateral.

OPERATIONAL CHALLENGES

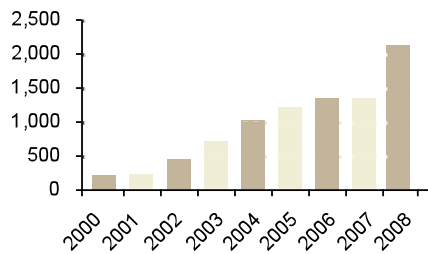
Even when collateral managers get these things right, there are many other significant operational issues to handle. Portfolio reconciliation is one of the most obvious issues, but some others are equally complex, tricky, and potentially resource-heavy “features” for managers, such as:

- On-boarding of new business, novations of or extensions to existing business
- Dealing with corporate actions and the intermittent cash flows that occur on debt instruments and equities
- Handling collateral liquidity
- Managing collateral eligibility criteria, haircutting strategies and issues around rehypothecation (the unfettered reuse of collateral taken by one party from another)
- Accounting for the different jurisdictional taxes that come into play as cross-border and cross-currency collateral activity occurs
- Reporting to a number of areas, not just risk management, but potentially to the board of directors and even to regulators and central banks

AUTOMATED COLLATERAL MANAGEMENT

Accordingly, it is easy to appreciate that hidden within the simple mechanism of converting “exposure” into “collateral” lie many new risks, of which legal, documentation, calculation, data delivery and quality, non-affirmation, pricing, and settlement are just a few. However, there is yet another challenge for current and future collateral management—transforming the way collateral managers communicate and interface with each other, their

EST. VALUE OF COLLATERAL (US\$ BIL)



Source: International Swaps and Derivatives Association 2008 Benchmarking Survey

ABOUT THE AUTHOR

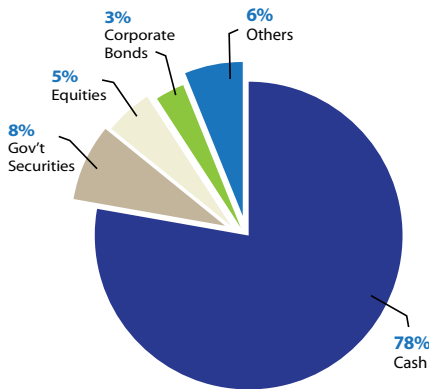
Tim Lind joined Omgeo as managing director, strategic planning in 2007. He is responsible for applying his industry expertise to help achieve Omgeo’s strategic objectives that will drive the continued growth of the firm. Prior to Omgeo, Tim previously held positions with GoldenSource, TowerGroup, SWIFT, Brown Brothers Harriman and Dean Witter Reynolds.



“More and more resources will continue to be devoted to the effort of efficiently managing collaterals, not only to handle the increased complexity of the underlying markets, but also to make the processes more efficient and provide a competitive edge.”

Andy Nybo,
Senior Analyst, Tabb Group

TYPE OF COLLATERAL RECEIVED



Source: International Swaps and Derivatives Association 2008 Benchmarking Survey

custodians and their brokers. This is where the processes and methods are at their least resilient and the point where risk mitigation is at its most vulnerable.

As such, there is a critical need within the market to create an open, secure and resilient messaging platform that not only enables near zero-touch collateral management, but also ensures that the act of risk transfer and diversification does indeed lead to significant risk reduction.

These can be viewed generally as internal opportunities for improvement, and are likely to be specific for each and every collateralizing party. However, this opportunity requires a quantum leap on an industry and vendor-wide basis. It requires the introduction of harmonized, open messaging and communications between collateralizing parties to mitigate some of the most hidden, transferred risks lurking within collateral management.

Collateral management is all about converting intangible credit risks into tangible risk mitigation. As long as email and the telephone are the predominant means of communication, there is considerable weakness and great potential for failure in what should be an automated end to end process.

Establishing efficient collateral-management processes within individual firms and across the community is no small undertaking. There is a lot of work to be done to establish best practices, cross-industry workflows and operational standards. If derivatives and other innovative products are here to stay (and they are), the time has come to make the effort. To truly help the industry progress, market participants must prioritize and determine how quickly they can implement changes to benefit all counterparties. Ultimately, if firms do not effectively manage counterparty risk and continue with inadequate operational processes, they are just trading one risk for another. If it's true that we learn more from our failures than from our successes, the lessons we take away from this crisis should allow us to emerge as a stronger industry.

▶ ABOUT OMGEO

Omgeo creates certainty in post-trade operations through the automation and timely confirmation of the economic details of trades executed between investment managers and broker dealers. Every day Omgeo enables an efficient community of more than 6,000 financial services clients in 46 countries to manage matching and exception handling of trade allocations, confirmations, and settlement instructions. Omgeo has also extended its trade lifecycle coverage to include counterparty risk management, which supports end-to-end collateralization and

reconciliation across multiple asset classes. Across borders, asset classes, and trade lifecycles, Omgeo is the global standard for operational efficiency across the investment industry. Formed in 2001, Omgeo is jointly owned by the DTCC and Thomson Reuters.

OMGEO & COUNTERPARTY RISK MANAGEMENT

With Omgeo ProtoCollSM for collateral and margin management and Omgeo CrossCheckSM for portfolio reconciliation, you can:

- Actively handle and effectively mitigate the credit risks to your counterparties

- Optimize and utilize your collateral inventory securely according to your risk profile and business needs
- Obtain complete transparency and achieve a bilateral, accurate understanding over your portfolios of open transactions (positions and breaks) with counterparties
- Automate and streamline your margin call processes
- Manage all of this within one of the most trusted and secure communities in the financial world, Omgeo.

To learn more, please visit: www.omgeo.com/counterpartyriskmanagement



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