

VISIBLE RISK IS MANAGEABLE RISK

THE MANAGEMENT AND CONTROL OF RISK is at the heart of both the theory and the practice of trading and investing in financial markets. Nothing illustrates this better than the chief measure of success in investment management: risk-adjusted return. But the spectacular misjudgments of risk that caused the massive losses of 2007-2008 means improving risk management is now the highest priority on all sides of the securities industry. Investors are demanding a proper understanding of the risks that fund managers, broker-dealers and banks are running on their behalf. This is fuelling the demand from market intermediaries for a comprehensive and consolidated view of all the risks that they are incurring on behalf of their shareholders as well as their clients. Which is why Omgeo is now offering a portfolio of products and services designed specifically to give banks, broker-dealers and fund managers full transparency into the wide variety of risks they run in the post-trade, pre-settlement space. Chief among them is Omgeo Central Trade Manager, which gives buy- and sell-side firms full visibility into all of their transactions across multiple asset classes, allowing them to match and confirm the details of their trades with counterparties and allocate them accurately between different funds. It also offers users access to a global network of buy- and sell-side firms, allowing information to be exchanged efficiently. In 2010, Omgeo CTM users will also be able to send matched and confirmed trades directly to central counterparties (CCPs) for clearing and netting ahead of settlement. Through its new offering, Omgeo ProtoColl, Omgeo has already further extended its coverage of post-trade processing to increase transparency and efficiency in the management of the single most important tool in risk mitigation: collateral. The solution is complemented by Omgeo CrossCheck, a centralized reconciliation tool that helps trading parties take an active, rather than reactive approach to agreeing the exact content and value of portfolios, and by doing so leading to more accurate margin calls and fewer disputes. Omgeo ProtoColl absorbs information about OTC derivative transactions and positions, reviews them against the underlying documentation, calculates collateral requirements, identifies suitable collateral to post, and facilitates the exchange of collateral between counterparties. It enables collateral to be sent, received, upgraded and substituted quickly, transparently and efficiently. Both Omgeo CTM and Omgeo ProtoColl are supported by the recently upgraded and enhanced Omgeo ALERT database of standing settlement and account instructions. In combination, CTM, ProtoColl and ALERT offer market participants a set of central matching, automated reconciliation, collateral management, counterparty data management and automated communication services that cut the risks, increase the efficiency and enhance the transparency of post-trade operations. *Global Custodian* Editor-in-Chief Dominic Hobson talked to Leigh Walters, head of EMEA at Omgeo, and Simon Lillystone, business development director, ProtoColl, Omgeo, about how increased transparency can boost investor confidence, cut costs and increase profitability by giving banks, broker-dealers and fund managers better control of operational risks.

Hobson: Transparency is one of those terms that means different things to different people at different times. What does it mean to your clients now?

Walters: On the buy side, both our institutional fund management and hedge fund clients are under pressure from their investors to provide more transparency into their operations, so that they can understand better the balance between risk and return. On the sell-side, broker-dealers want to better understand the profitability of clients. Transparency offers them data they can use to work out which clients are profitable, and which are not.

Lillystone: Buy-side firms were always uncertain about the credit and collateral risks associated with OTC derivatives, so any information which can illuminate those risks is important, not only to them, but to regulators, and indeed to the overall level of confidence in the market. A broader range of institutions, especially from the buy side, are now making use of OTC derivatives, and they need to be confident that their counterparts are treating the risks as seriously as they are.

Hobson: Gaining transparency into risk exposures is one thing, but managing them is



another. How can firms actually use their better understanding to manage risks?

Lillystone: Risks cannot be eliminated, but they can be transformed into something more manageable. Anybody using collateral is trying to convert an intangible counterparty credit risk into something tangible, which can be realized in an event of default. But collateral itself creates valuation, liquidity and settlement risks. These can be mitigated by more efficient management of the process of collateralization, making wholesale use of reconciliation tools, and especially by increasing the level of automation in collateral management.

Hobson: Which parts of the post-trade, pre-settlement chain in particular are in need of higher levels of automation?

Walters: An area ripe for automation is the links down to the CCPs and the central securities depositories (CSDs). Omgeo is working with EuroCCP, to provide fund managers with a service in which matched trades are netted through a CCP before being passed to the CSDs for settlement. Settlement is a standardized process in most markets, but every transaction is settled on a gross, bilateral basis. By netting it down, we can make it more efficient. We also believe that, by eliminating counterparty risk as part of a central matching process, we can encourage smaller investment managers to consider Omgeo CTM as a suitable solution to their trade processing needs.

What Omgeo ProtoColl Does

- Margin Call and Agreement Management
- Portfolio Reconciliation
- Cash Collateral Management
- Collateral Orders and Inventory

What Omgeo CTM Does

- Enables Same Day Affirmation
- Reduces trade fails
- Central matching of trades in multiple asset classes
- Access to a global network of buy- and sell-side firms
- Automated link for the buy side to central counterparties*

*Due in 2010

What Omgeo ALERT Does

- Stores standing account and settlement instructions
- Automated enrichment of settlement instructions
- Automated updating of information
- Ensures data remains in line with industry standards

Lillystone: My immediate answer is “at the coal-face”: providing tools to collateralizing parties that allow them to deliver and receive key messages, such as margin call notices, automatically and without the use of emails and PDFs—the current de-facto standard in the OTC world. Another key automation concerns the process by which the transaction data held by each party to a portfolio of OTC derivative trades is reconciled, since, at the moment, the parties often have diametrically opposed views of the same set of transactions. This is a requirement fulfilled by Omgeo’s reconciliation solution, Omgeo CrossCheck. Whilst centralization of information in data warehouses and the creation of OTC derivative exchanges are routes being investigated by market authorities and regulators, a great deal can be done by OTC derivative users internally to improve the quality of their data.

Hobson: What role can be played here by the ALERT data repository?

Walters: Omgeo ALERT is important in enabling Omgeo CTM users to enrich transactions with static and reference data automatically. In the past year, we have been working hard to make significant upgrades to the database. It now covers multiple asset classes. We have also introduced filters at data entry points, and added tools to audit the information in the database as well, so we can now tell users what proportion of the broker and

counterparty account and standing settlement instruction data is compliant with Securities Market Practice Group (SMPG) rules. They can then clean it up.

Hobson: The link from Omgeo CTM to EuroCCP can help users cut counterparty risk. Are there any other benefits?

Walters: The main driver for buy-side firms is the mitigation of counterparty credit risk. Central clearing will protect the buy side against the permanent default of a counterparty. The driver is different for sell-side firms. Although they are exposed to a large number and great variety of counterparty credit risks on the buy side, their primary goal is to cut the costs of dealing with multiple counterparties, and especially with that, the minority of smaller buy-side firms which still process trades manually. The same is true of the custodian banks. They are more motivated by the operational cost savings than the counterparty credit risk mitigation.

Hobson: How large are the savings that can be made?

Walters: Bringing netting through a CCP to the OTC equity markets offers potentially massive savings. On a typical day in October this year around 160,000 transactions were matched through OASYS Global and Omgeo CTM, which amounts to around 40 million trades a year, of which we estimate around two in five are susceptible to netting. It is not possible to net the markets in the United Kingdom, for example, because of stamp duty constraints. If we then assume netting makes settlement 75% more efficient, and while settlement fees vary greatly, if we estimate an average settlement cost in Continental Europe today of €10, the settlement of matched and netted trades through a CCP could save the European securities industry hundreds of millions of euros in settlement fees. It is not only settlement fees which are significantly reduced through this new model of buy-side clearing, the introduction of a central counterparty reduces the overall cost of operations through the elimination of failed trades.

Lillystone: Fundamentally, the key test of the efficiency of collateralization will always be the rate of recovery from realizing the value of the collateral if your counterparty fails. Weaknesses in operational processes cannot just delay but even negate that rate of recovery. In this regard, liquidity risk [the ability to obtain maximal potential value for collateral in different market conditions] is potentially problem-



atic, and concentration risk [in which a market participant is over-exposed to a particular form of collateral] plays a big part. Other fundamentals, which should be obvious, are being able to issue accurate margin calls, on time to counterparties, and vigilantly following up on securing collateral within deadlines. However, it is often more difficult than imagined. Firms may be operating off dozens of different systems across multiple business lines, which all need to be considered to obtain a holistic view of counterparty credit risks across all their trading businesses, not all of which may be collateralized. Then there is the sheer volume of documentation that has to be managed. The number of Credit Support Annexes (CSAs) for OTC business managed by the large broker-dealers has risen to 20,000 to 30,000 today from perhaps 1,500 to 2,000 five years ago as the buy side has come on board. Broker-dealers were previously prepared to incur the risk, costs and inconvenience when they could improve the rate of return on collateral by rehypothecating it, but the collapse of Lehman Brothers has made this practice hard to sustain. At the same time, the buy side is looking to diversify its counterparty credit risk by using a number of brokers simultaneously to intermediate its OTC derivative trades, rather than channel all their business through one so that is also pushing broker-dealers to increase their operational efficiency in the OTC derivative markets.

