Trinity Fund Administration Ltd

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Counterparty Exposure Risk

Series 1.2

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Counterparty Exposure Risk

Counterparty risk is defined by the UK's Financial Services Authority (FSA) as the risk that a counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transaction or portfolio of transactions with the counterparty has a positive economic value at the time of the default.

Looking at the example of a homeowner hiring a contractor, it is considered good practice to obtain references and otherwise complete due diligence as a natural part of the decision making process, to reduce the chance of default risk by the contractor. However when we approach a large bank often this step might not be considered necessary, as we may trust that this entity adheres to regulatory requirements which are designed to ensure the stability of such institutions. As there is no real-time way to monitor the balance sheets of key counterparties, hedge fund managers are often left with finding other alternatives to protect themselves from the fallout when one of their financial counterparties has a meltdown or otherwise does not live up to its contractual obligations.

Learning from Failure

Counterparty risk is a challenge faced by all players in the financial industry. Pre-2008, banks believed that hedge funds were one of the greatest sources of counterparty risk. However, in 2008 when Bear Sterns was rescued by JP Morgan and then Lehman Brothers Holdings Corp ('Lehman's') collapsed, it became clear that the risk could be reversed, and banks have the potential to pose a major risk to hedge funds. When Lehman's folded in September 2008, many funds were frozen with trades they couldn't close and therefore resorted to invoking side pocket and gate provisions in order to manage liquidity. In the four years since then, managing counterparty risk has become a critical component of hedge fund operations.

Lehman's was not necessarily an isolated case; demonstrated by the recent downfall of US brokerage firm MF Global in late 2011, which has been attributed to exposure to Eurozone debt, as well as the common industry practice of re-hypothecation. Hypothecation is the use of collateral to back a debt, and brokers often use collateral which has been deposited by clients to back their own proprietary trades and borrowings (re-hypothecation), a practice which is perfectly legal in the US and UK. According to an article by leading US law firm Crow & Associates, legislation in these jurisdictions also appears to allow this collateral to be re-hypothecated more than once, and often brokers end up re-hypothecating assets several times, known as 'churning'[1].

In the MF Global case, an estimated $1.2billion in customer funds disappeared, and the firm's CEO Jon Corzine testified that he did not know what happened to these funds. Speculators have suggested that the fact that MF Global used re-hypothecated collateral to invest in repurchase agreements in large sums of Eurozone debt resulted in this loss of funds. Hedge funds once again took a hit when this happened, despite the major efforts by global governments to control the risks taken by financial institutions. As a consequence, whether it's a Wall Street investment bank, or a Canary Wharf prime broker, alternative asset managers need to limit their counterparty risk effectively.

[1] Crow and Associates LLC, December 2011 Newsletter

Regulatory Support

Worldwide, governments are currently attempting to address the systemic risk posed within financial markets. There have been calls for the separation of investment and commercial banking, after the Glass-Steagall Act was repealed in 1999. (Glass-Steagall was enacted in 1933 as a reaction to the Great Depression in the 1930s.) There are arguments which suggest that the risks taken in securities lending should be completely separated from commercial bank customers' funds. US law currently requires a financial institution to limit its exposure to a single entity to less than 25%. However as the US ushers in regulation to prevent another financial crisis through the Dodd-Frank act, the Federal Reserve now proposes that large, important institutions limit their exposure to single entities to 10%.

The FSA in the UK has also recently issued guidelines including frameworks and procedures to mitigate counterparty risk which apply to smaller financial entities as well as large institutions. Specifically, these guidelines are aimed at central counterparties (an entity that interposes itself between the two counterparties to a transaction, becoming the buyer to every seller and the seller to every buyer i.e. prime brokers). For fund managers, it is important to understand if their prime brokers adhere to these, or similar, guidelines.

In Europe, a legislative proposal has also been submitted by the European Commission on derivative transactions and central counterparties (CCPs). The European Market Infrastructure Regulation (EMIR) states that 'a CCP's main purpose is to manage the risk that could arise if one counterparty is not able to make the required payments when they are due i.e. defaults on the deal'. EMIR's proposed legislation aims to render the OTC derivatives market more transparent in order to facilitate credit and operational risk management. The proposal states that there will be thresholds which will exempt some CCPs from the legislation but details are yet to be released.

Additionally, the Committee on Payment and Settlement Systems and Technical Committee of the International Organisation of Securities Commissions (CPSS-IOSCO) issued a report in early June 2012 which outlines high international standards for derivatives market intermediaries. These standards relate to prime brokers, enabling them to manage counterparty risk, limit the risk of fraudulent behaviour, and mitigate systemic risk in the OTC derivatives market.

Implications for Fund Managers

The monitoring of counterparty risk is an on-going process with a growing field of service providers offering various solutions, and choosing the right broker and service providers are key steps to managing risk exposure. Best practices for proactively managing counterparty risk include ensuring robust internal procedures relating to portfolio and risk assessment, formalizing outsourcing procedures and the use of portfolio management systems, separating banking services from the brokerage relationship and using a recognised and regulated third party which is independent from the financial counterparty for the fund's administration. In much the same way that independent directors provide confidence and oversight of the fund, an arm's length third party administrator can help to ensure the accuracy of reporting for the manager by offering independent daily trade reconciliation, monitoring and review of the processes during the period, as well as independent calculation of the fund's Net Asset Value (NAV), thus reducing risk and increasing shareholder comfort and confidence.

The fact that institutional investors now dominate the hedge fund market means that investor demands are becoming increasingly sophisticated. This is a global trend seen in developed nations as well as emerging economy regions such as Latin America and the Middle East. The various media reports on the risk of fraud as a result of lack of financial transparency have urged investors to look for information on where assets are held, thus the fund manager needs to be able to provide clear information on the fund's custodian, sub-custodian, brokers and bankers. The agreements with these counterparties will outline this information, as well as procedures in the event of a credit default and therefore should be scrutinised carefully before such contracts are executed.

When choosing a custodian or a prime broker, it is extremely helpful to take advantage of an experienced industry service provider who can assist with introductions to the relevant providers, as well as provide input with regard to which providers are strong in a particular area or in relation to a particular investment strategy. Third party independent administrators with no ties to a financial institution can assist in this regard. They will have experience with a wide array of global financial firms, and are generally happy to work with any institution that a client brings to the table. Equally, they can provide introductions to a choice of industry service providers with whom they work on an on-going basis. Likewise introductions/references from industry peers can be very useful and should be utilised.

Employing more than one broker and banker is an effective way to diversify and minimize exposure to any one institution; however one's fund size may limit one's ability to undertake multiple relationships and with fewer creditworthy institutions to choose from, the overall risk remains an issue. If a manager's fund is large enough, they can use such a multi-prime model, contracting more than one prime broker, although they must be aware that this will increase the complexity of the middle and back office operations of a fund. In order to help manage this complexity efficiently, a third party fund administrator can provide a high level of experience, automated processes and coordination of the disparate data repositories. This is provided while helping to monitor exposures from a risk management perspective and ensuring cost efficient service, as well as accurate real-time reporting.

One operational mechanism which can be used to protect a fund manager's assets is the use of segregated accounts. Subject to size the of Assets under Management etc, the manager may be in a position to negotiate terms whereby the fund's assets are held in accounts which are segregated from the general assets of the relevant institution and thus not available for re-hypothecation. An alternative, but related tactic that fund managers have been using to manage counterparty risk in a prime broker is the use of 'amber terms'. These terms state that if a broker's credit default swap (CDS) spread goes beyond a certain point, the unaffected assets are moved to a separate account as a precaution. Amber terms should be written into a prime broker agreement, and a fund manager can formulate the terms by carrying out due diligence on a prime broker and evaluating its exposure to various markets, industries and regions.

In a world where counterparty risk is widespread and seemingly, increasing by the day, fund managers have some options available in order to limit counterparty risk. These include diversification of counterparties (where possible), industry referrals and references, service provider due diligence and defined risk avoidance procedures.

Conclusion

There is no panacea from counterparty risk in today's world. A recent example is the story of PFG Best, the US futures broker which was revealed to be holding $5million in a bank account which it had stated held $225million. This missing $200million was concealed, whereby the broker forged documents which it sent to the National Futures Association. PFG Best holds less than a tenth in assets of what MF Global held but it serves as reinforcement that counterparty risk continues to be an issue. What serves as an even greater warning was when credit ratings agency Moody's downgraded 15 of the world largest banks in June. Moody's has effectively downgraded the credit worthiness of the entire financial industry, highlighting the risky times we live in. The old approach of 'banks are safe as houses' is no longer acceptable and duly diligent monitoring of all relevant counterparties is unfortunately a sign of the times and an issue that all fund managers need to address.