Counterparty Risk: Are We Leveraging Our Tools?

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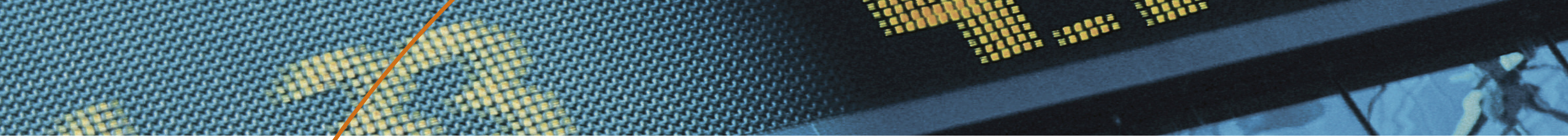

Counterparty Risk: Are We Leveraging Our Tools?

Counterparty risk has long been a source of concern for risk managers. However, the financial crisis brought new urgency to counterparty risk management for risk practitioners, regulators and financial firms alike, as exposure to collapsing giants like Lehman Brothers and AIG left the industry reeling. That urgency has been punctuated by the global economy's current struggles, as firms grapple with new regulations, the European debt crisis and fears of a double-dip recession.

The failure of MF Global in October has only heightened concerns about counterparty risk and the continued vulnerability of the financial industry to systemic risk.

Current technologies and techniques allow for more sophisticated and effective approaches to counterparty risk than those that fell short in 2008. Yet there are many barriers to successful adoption and implementation, and significant changes will be required, from the global regulatory level all the way down to individual departments at financial firms around the world. If the end goal is a standardized method of quantifying risk exposure among financial institutions, the industry and regulators have considerable work to do.

From a technology perspective, the capabilities are there. Financial firms can build or purchase risk systems that can gather and analyze the data needed to perform large-scale exposure assessments and more accurately calculate CVA, or credit valuation adjustment, which is the difference between the value of a risk-free portfolio and one that takes into account the possibility of a counterparty's future default.

But while the tools—and quantitative techniques—may exist, it is a rare organization that has the funding to undertake an overhaul of risk management systems. "I don't expect anybody to revamp risk management processes and risk technology for the next three or four years, spending hundreds of millions of dollars from hardware to networks to software development," says Sinan Baskan, vice president of business development in financial markets at Sybase. "However, there is some kind of prioritization that needs to take place so that gradual improvements can be accomplished in due course."

Organizational Change

Budgetary restraints are hardly the largest obstacle as the industry grapples with counterparty risk. Financial firms need to make major organizational changes before they can aggregate and integrate counterparty data in a meaningful way.

Traditionally, senior management has viewed individual business units as separate entities with different goals and strategies. "No one has a broad view, not even the CEO, of what's going on," says Allan Grody, president of Financial InterGroup.

To perform the kinds of exposure assessments that regulators are demanding, institutions will have to look at aggregated portfolios, consolidated information, cross-business unit reporting and the factors affecting portfolio and collateral valuations, all on a real-time basis. That will mean integrating and consolidating data as it moves up the layers of the organization.

For some banks, one of the positive byproducts of the Troubled Asset Relief Program was that it made the shortcomings in their reporting hierarchies readily apparent. When they had to report back to the government on their TARP funding, they quickly realized that they weren't doing the aggregation and consolidation necessary to provide that data. "It was a learning experience of how information gets stuck at lower levels and doesn't rise to where actual decisions need to be made," says Baskan.

The structures that institutions built for TARP reporting provide an example of how to bring data together in an enterprise-wide view. But firms will still need to account for new methodologies, data quality, transparency, and the flow of information across business units as they adapt their organizations to better deal with counterparty risk.

Regulatory Impetus

Much of the impetus for this change, of course, will be compliance with emerging regulations. Frameworks like Basel III and Dodd-Frank will require that firms have a better idea of their risk exposures and manage their collateral appropriately. But the specific rules are still somewhat of a moving target.

While the counterparty credit risk proposals in Basel II have already been enacted in the European Union and accounted for in the U.S. regulatory framework, the Basel III requirements are still being changed and refined. Unlike its predecessor, Basel III will require banks to halt capital for the credit migration of the counterparty, and more market-related factors have been incorporated into capital requirements.

"What we are seeing from a regulatory perspective," explains Peter Went, senior researcher in the Global Association of Risk Professional's Research Center, "is that Basel III is slowly moving to assess the value and the changes in the value in these exposures to better reflect the inherent riskiness and the inherent stochastic nature of the financial markets."

There are differences, however, between the capital requirements mandated in Basel III and those in Europe's Capital Requirements Directive. In the U.S., the Dodd-Frank Act doesn't directly address counterparty credit risk as such, but it does introduce a framework for financial institutions with large exposures, and the regime also sets limits on the concentration of credit exposures a bank holding company can have with unaffiliated companies. In July, federal regulators issued guidelines on how banks should practice effective counterparty credit risk management.

Global Uncertainty

As regulators struggle to finalize their regimes, financial institutions are left with uncertainty about the eventual demands. If the final frameworks differ significantly, it will create an uneven playing field. "We have to create rules that all banks have to follow, because otherwise the way we deal with the exposures, the way we quantify exposures, the way we require risk capital against those exposures, can essentially create areas where regulatory arbitrage is incentivized," says Went.

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But creating global standards for the entire industry is a daunting task, and no solution is likely to be seen as ideal for any one segment. Exchange operators do not want regulations that impede their offering new services and information products, or place additional accounting and recordkeeping burdens upon them. The hedge fund community wants competition and pricing advantages, but they don't want fragmentation of liquidity. Investment banks want to be able to continue creating arbitrage opportunities and developing fee-based services. As the various groups lobby for their own needs, it waters down the outcome of regulation.

The result is too many compromises, says Baskan, "rather than a set of principles; a comprehensive view of the balances that must be maintained in the macro economy which would shape the kind of risk management framework we can manage to."

Stress-Testing Questions

Stress-testing is an area that has been receiving considerable emphasis from regulators. However, deciding what the scenarios are, and who defines them, is an open question.

For institutions, the objective of stress-testing is generally to determine successful trading strategies across different assets or across different trading venues. Regulators, on the other hand, see stress-testing as an early-warning system. Regulators have to worry about stress-testing for the trading book and the banking book in a way that gives a normalized result for the institution's entire balance sheet exposures.

"But if they borrow and steal from the institution's tool book to determine what stress-testing practice should be, the regulators will be left at the altar, so to speak," says Baskan. "They won't get their job done because their tool box will not be complete."

Stress tests done on a standardized global basis are suspect, according to Grody, because of the selectivity being exercised. In European stress-testing, he says, "they decided not to stress the portfolios for sovereign debt, because they knew no one would pass the test."

Another limitation when developing stress-testing scenarios, is the reliance on historical data and a hindsight view of the most recent crisis. For stress tests to be valuable, models and the context in which they are operating must be constantly reevaluated.

Conclusion

The real challenge for both regulators and industry participants, is being able to understand exposures in real time across counterparties, markets and asset classes. There's technology that can do that, but the solution will not come from technology. The solution lies in institutions making better use of the information they have.

"The first step is to achieve some transparency within the organization to the information that is already there and is already flowing across different systems—that's the practical way of making information flow into the right hands sufficiently early," says Baskan. "Given the budgets and the financial health of the companies, I think probably that's a good place to start."

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