

The financial sector anticipates improvements to OTC Credit Transfer Products interoperability

by Martin Sexton



The recent banking crisis has provided the industry with the needed wake-up call, especially in relation to understanding the risks associated with OTC derivative instruments. When Lehman Brothers and the Icelandic banks filed for bankruptcy, there was a sudden panic across the financial sector to quantify one's exposure to these counterparties.

In January 2010 the publication, "Review of the Differentiated Nature and Scope of Financial Regulation" released by Bank for International Settlements, recognized that inadequate management of risk specifically associated with credit transfer products (Credit Default Swaps and Financial Guarantee Insurance transactions), in some instances, contributed to the instability of confidence in the financial markets. The United States President's Working Group on the Financial Markets also identified that reform is needed to clearing and settlement processes. Other post crisis lessons learned reviews have focused on the need to promote automation, standardisation and interoperability of infrastructure as well as better management of counterparty risk.

Given the complexity of OTC derivative instruments, linking the contractual terms and conditions with business process and specific reference data definitions, is a challenge for any organization. Ultimately, one should be aiming to automate as many processes as possible, including credit risk management, clearing, settlement and regulatory reporting.

Originally, Credit Default Swaps (CDS) were designed to hedge cash positions held by a party with the equivalent derivatives, however as time has passed credit transfer products have matured into tools for credit risk management in their own rights, with volumes traded outstripping the volume of the reference obligation (normally bonds) outstanding in the market.

Assuming physical delivery, the buyer of the protection is obligated to supply the seller, at the time of default, with the equivalent reference obligation. This results in increased volatility of this reference obligation, post default. The solution is to create a cash equivalent mechanism, hence the creation of event auctions.

The International Swaps and Derivatives Association ("ISDA") has been at the vanguard of addressing this issue and in 2009 published a new framework to facilitate settlement of credit default swaps. This framework is defined in the "Auction Settlement" and "Restructuring" supplements to the "2003 Credit Derivative Definitions". These addendums introduced important changes into the CDS market providing an alternative to physical delivery, which are applied to all new contracts. These supplements resulted in the creation of two protocols, one to cover hard events, such as Bankruptcy or "Failure to Pay", known as the "Big Bang" protocol and the other soft events (i.e. reconstruction) were covered by the "Small Bang" protocol. These protocols provide market participants with an efficient way of addressing the settlement

issues as well as offering the capability to amend existing documentation in order to utilize the auction facility for pre-existing agreements.

Counterparty risk management has been the real hot potato for some time, however the global recession has pushed it to the forefront. It was recognised that buyers of protection did not properly assess whether sellers could meet their obligations and the sellers did not adequately measure the potential losses. Merely identifying the buyer and seller of protection in a deal has been shown, in a number of cases, not to be sufficient. Guarantees may be in place, between protection buyers/sellers and other third parties, which results in the ownership of obligations or collateral posted being transferred to a third party, at time of distress. Attempting to understand ones exposure to a counterparty “in default” is rarely simple, factors come into play such as the timing of the delivery of the notification of default. To emphasis this point it’s worth considering the scenario where the counterparty on a deal was Lehman Brothers Special Financing Inc., a foreign subsidiary of the parent company. It filed for bankruptcy three weeks after its parent; leaving non-defaulting parties with exposures and unable to trigger a default.

Given the complexity inherent in counterparty risk management, there has been the recognition that to fully understand the relationships and guarantees in place between business entities, these interdependencies need to be understood and effectively modelled. In addition, the industry would benefit from a globally acceptable unique business entity identifier, as recognised when ISO Working Group 8 originally defined the draft International Business Entity Identifier (IBEI) standard. Since its publication, in late 2005 and its rejection by the ISO community, the working group has descoped its focus and is now developing the Issuer and Guarantor Identifier (IGI). Whether this or an alternative will be able to fulfil the needs of counterparty risk management, we will have to wait and see.

Inadequate posting of collateral ran a close second to deficiencies in counterparty risk management. The absence of collateral posting requirements for highly rated protection sellers, AAA rated (or equivalent), allowed those organisations to accrue large OTC portfolios. This highlighted the need for the posting of collateral, that other lesser rated organisations would normally be expected to adhere to. Given the close relationship between identifying the quality of the organisation and its posting requirements, credit rating agencies also came under the spotlight. This resulted in regulators proposing the creation of a framework to regulate credit rating agencies. It is worth appreciating that the treatment of collateral also varies from jurisdiction to jurisdiction. For example, under NY law rehypothecation is permitted, which means that the collateral taker (i.e. the holding agent) can transfer the collateral to a third party to cover its own exposures, at time of default. This is not the situation within other jurisdictions, such as under English law.

The consultation process on OTC derivative products has also identified the need for greater standardisation of products as well as reform to clearing and settlement processes. There has been an ongoing process of reducing the number of distinct contract variants. At the last count there were 22 styles Credit Default Swaps and further standardisation of agreements is expected to continue, even without a nudge from legislation. The introduction of Central

CounterParties (CCPs) and the definition of uniform clearing rules have been received as a positive move, nonetheless, there are numerous OTC products that calculating valuation margins and collateral posting do not apply, and therefore they do not lend themselves to clearing through a central counterparty. In addition to the use of CCPs, the establishment of central close-out counterparties with the appropriate electronic infrastructure is also on the radar.

Regulators have also been examining their reporting requirements, which it is recognised, needs to be enhanced. From a regulating reporting perspective, identifying the buyer/sellers of protection of a specified reference obligation is not necessarily providing the whole picture. Such reporting only offers a snapshot at deal initiation, the focus thereafter has been on monitoring the risk associated with reference obligation and regulators have used CDS spreads to achieve this. Nevertheless, the collapse of Lehman Brothers highlighted the need to take a closer examination of counterparties involved in the deal throughout its lifecycle, rather than just the reference obligation itself. There is the need to understand any guarantees that are in place between parties, which may not be directly involved in the deal. When a party defaults, “Does their obligation(s) transfer to a third party?”, “Does the ownership of collateral posted, transfer to a third party?” The regulators need to be provided with the capability to monitor the capital requirements of writers of credit transfer products and positions of market participants.

Credit should be given to ISDA, who have been proactively involved in addressing the issues raised by the various investigations. In addition, to defining the settlements auction supplements and the associated protocols, it has been responsible for instigating the creation of the FpML Reporting/Regulatory Reporting Working Group which has been tasked with extending the current version of the FpML standard to support the requirements for reporting OTC derivative positions between market participants and the regulators. Its mandate encompasses, assessing all current and potential future needs, including regulatory reporting, portfolio reconciliation and collateral management, as well as counterparty risk.

From a reference data perspective, there are a number of areas that organisations need to examine in more detail. Deficiencies in counterparty risk management, collateral management and settlement, has highlighted the need for every organisation to audit its process and data models to ensure that they align with their active derivative agreements. The efforts undertaken by the ISDA/FpML Reporting/Regulatory Reporting Working Group will make this task a great deal easier. A new version of FpML that addresses the issues raised, is planned for release shortly.

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