The Basel III Accord – What Is It For?

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Welcome to the Global Risk Update for Q3 2010. In this issue we have six original articles which consider the latest risk issues impacting the financial services industry. We have outlined the revisions that the Bank for International Settlements is intending to make to Basel II known as Basel III. Although we do not have the full details at this stage (they will be available for the next Global Risk Update once the final paper is published in November) we do know the broad and extended thrust of the revision. Our lead article serves to highlight some of the issues and real concerns about the direction of regulation.

The first of a series of articles from Tracy Williams takes a look at a current area of major risk which has also received significant regulatory attention. Tracy sets the scene regarding reassessing credit models and also provides guidance on some of the problems faced. Mark Andrews reminds us that customer relationship management (CRM) is a critical business tool to retain existing clients and attract new ones when so many firms are finding business difficult to finance given the current market problems. Clearly credit risk remains the key risk that banks are facing due to the state of the global economy. In his third Credit Risk article Simon Ling-Locke further explores these issues.

Business Continuity Planning for banks and financial institutions is described by former HSBC and Merrill Lynch operations expert and internal auditor, Paul Kilduff. He considers the key issues in operation risk areas, highlighting where action should be taken.

While Basel III is one response to the financial crisis by regulators another reaction has been the headlong flight towards the development of central counterparties and clearing facilities for over the counter derivative products. Some of the problems that we foresee and some of the likely consequences of this development are described in the last article of this edition.

There is much that is likely to change over the next few months and as regulatory papers are issued we will continue to both post and discuss them on our dedicated professionals LinkedIn Group, the Risk Reward Global Risk Forum. You are cordially invited to join. We will also continue to provide thought provoking and ‘bleeding-edge’ articles to enable you to steer your way through the regulatory and commercial responses maze that are developing at great speed. That this change is occurring during an aggressively negative market when so many future problems can so easily be envisaged only serves to exacerbate both the problem and sometimes our collective frustration. Risk Reward is working with firms to develop solutions in all risk and regulatory areas whilst also lobbying for sanity in regulation on behalf and directly for our clients.

Do contact us if there is anything that you think we can help you with and in the meantime enjoy this edition of the Global Risk Update Q3 2010.

With best wishes

Dennis Cox BSc, FSI, FCA
Chief Executive Officer

To The Editor
Do you have risk issues in your organisation or region you would like to share? Email your thoughts to the Editor at DWC@riskrewardlimited.com

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At its 12 September 2010 meeting, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced a substantial strengthening of existing capital requirements and fully endorsed the agreements it reached on 26 July 2010. These capital reforms, together with the introduction of a global liquidity standard, deliver on the core of the global financial reform agenda and will be presented to the Seoul G20 Leaders summit in November.

The Committee’s package of reforms will increase the minimum common equity requirement from 2% to 4.5%. In addition, banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%. This reinforces the stronger definition of capital agreed by Governors and Heads of Supervision in July and the higher capital requirements for trading, derivative and securitisation activities to be introduced at the end of 2011.

The Detailed Requirements
The minimum requirement for common equity, the highest form of loss absorbing capital, will be raised from the current 2% level, before the application of regulatory adjustments, to 4.5% after the application of stricter adjustments. This will be phased in by 1 January 2015. The Tier 1 capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, will increase from 4% to 6% over the same period. So the great rushes that we have for new regulation enables an additional four years to elapse before these measures are introduced.

The paper also requires the maintenance of a capital conservation buffer above the regulatory minimum requirement be calibrated at 2.5% that must also be met with common equity, after the application of deductions. The objective of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks are allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distributions.

This of course is counter to the objectives and will just mean that firms are required to keep an additional level of capital to be held for a rainy day – when they will be unlikely to be allowed to use it.

A countercyclical buffer within a range of 0% – 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances. Even though the rules as discussed in the last update make very little sense and will probably result in a zero capital increase, the rules have been implemented. While the purpose of the countercyclical buffer

Dennis Cox is the Chief Executive of Risk Reward Limited and chairs the Chartered Institute of Securities and Investment Risk Forum based in London. In the opening article of this update he briefly addresses the so-called Basel III Accord, the regulators response to the financial crisis and suggests how this might impact the industry.
is to achieve the broader macro prudential goal of protecting the banking sector from periods of excess aggregate credit growth, it is unlikely to achieve anything at all. For any given country, this buffer will only be in effect when there is excess credit growth that is resulting in a system wide build up of risk and it remains almost inconceivable that any country would admit to this having occurred.

These capital requirements are supplemented by a non-risk-based leverage ratio that will serve as a backstop to the risk-based measures described above. In July, Governors and Heads of Supervision agreed to test a minimum Tier 1 leverage ratio of 3% during the parallel run period. Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration. No I am not joking I did say 2017 and 2018. Of course by then the rules will have been replaced by a new set of rules.

What is the Point of the Changes

It is clear that the regulators had to reflect on the crisis and take action to deal with the public clamour for change. Of course the Basel II rules had not been fully implemented and did represent a partially flawed solution to the capital conundrum — but at the heart of the issue is what is the capital for? Is capital the best way to protect the global industry and if it is — should the capital be held by the banks?

I take the view that it is clear that requiring each bank to maintain capital to meet in some ways the demands on capital of a stress based failure cannot make any sense. It will only result in an inefficient use of global capital and the almost certain reduction in global activity. This in turn increases bank provisions for irrecoverable loans and will result in reduced bank profitability. The consequence can only be a requirement to raise additional capital or to increase the price of banking products.

Then there is always the question about whether additional capital in the banking sector would have averted the crisis. I can see no evidence to suggest that this is in fact the case. Remember we started with a liquidity crisis caused by an asset class (collateralised obligations) being undermined and consequently difficult to price, creating uncertainty. Capital will not change any of these issues — it will neither create liquidity nor reduce uncertainty in times of stress.

The good thing is that there is no real rush to implement these rules. The paper states that national implementation by member countries will only begin on 1 January 2013 although member countries must translate the rules into national laws and regulations before this date. As of 1 January 2013, banks will be required to meet the following new minimum requirements in relation to risk-weighted assets (RWAs).  

3.5% common equity/RWAs;  
4.5% Tier 1 capital/RWAs, and  
8.0% total capital/RWAs.  

The minimum common equity and Tier 1 requirements will be phased in between 1 January 2013 and 1 January 2015. On 1 January 2013, the minimum common equity requirement will rise from the current 2% level to 3.5%. The Tier 1 capital requirement will rise from 4% to 4.5%. On 1 January 2014, banks will have to meet a 4% minimum common equity requirement and a Tier 1 requirement of 5.5%. On 1 January 2015, banks will have to meet the 4.5% common equity and the 6% Tier 1 requirements. The total capital requirement remains at the existing level of 8.0% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital.

So we have a slowly increasing capital requirement heading out to 2015. Of course many banks already meet much of these requirements, but not always with sufficient common equity. There will be a requirement for some banks to raise more capital — but what is more likely to occur is that:

1) There will be further mergers of banks to create efficiency  
2) Many banks will reduce their main lending activities to effectively try to shrink their balance sheets  
3) Non-bank financial institutions will develop cost effective products which further undermine the position of the banks  
4) The rules will be revised further as more people question the suitability of these changes.

If you look at Annex 2 of the paper you will note that it is not until 2019 that everything has been phased in. The good thing is that regulation does after all not tend to last that long. Recognizing that Basel II went through a member of final version prior to the consolidated June 2006 final version, one wonders how many changes will be made to Basel III in the coming years.

Certainly since 2019 will probably be after the next crisis, by then we could expect to have a draft of Basel IV, or V...  

DWC@riskrewardlimited.com
It’s no secret corporate credit-risk managers rely on models and tools to help them make credit-risk decisions. They may be any combination of the following: credit or financial models, financial analysis, risk analysis, statistics, spreadsheets, financial ratios, market signals, market models, credit data, and credit research.

Those tools, if used properly, assist in making decisions about clients, counterparties, exposures, portfolios, industry risks, deals, transactions, or new relationships. Sometimes, however, if they are outdated, the tools are a hindrance to making rational, proper decisions. Or if they are unreliable, inflexible, or too mired in the past.

Models, analysis and tools themselves shouldn’t make decisions. Risk managers do. They help rationalize or support decisions. Ineffective use or even exploitation will lead to bad decisions or portfolio disasters that could take years to clean up. A risk manager doesn’t approve a deal, transaction, exposure or risk because a ratio or market indicator says so. But the ratio or market indicator should be a contributing factor in the final decision.

With the financial crisis waning, now is the right time to step back, reassess and rethink many of those credit models and financial-analysis methods or approaches. In fact, risk managers should reassess and rethink on an ongoing basis. Credit models and financial analysis should be dynamic, evolving, and flexible. After a crisis and after a period of portfolio restructuring, decision-makers should examine what worked and what should be tweaked and ensure that revised models can anticipate risks and downturns much better.

After a financial crisis, there is always room for improvement in corporate credit-risk analysis. This is the first of three articles examining why and how corporate risk models should be reassessed on an ongoing basis. Tracy E. Williams, Former Managing Director at JPMorgan, makes recommendations for model updates and shows how analysis can be forward-looking and anticipate unforeseen risks. The first article questions old habits, suggests new principles for analysis, and highlights the importance of detailed disclosure from borrowers and counterparties.
Questioning Old Habits and Old Ways

To start, risk managers should have a “state of the union” assessment of how they analyze borrowers and counterparties and assess the risk of doing business with them. They should ask:

1. What models and methods worked and didn’t work? What approaches, analytical techniques, financial ratios, or market indicators contributed to good decisions, risk aversion, risk reduction, sound portfolios, or proper risk management?

2. Which ones were best at anticipating unforeseen risks, hidden risks, and deteriorating or declining performance from clients and counterparties?

3. How should models and analysis be changed or transformed to be more predictive and useful? How should they be changed to be more forward-looking? When should unreliable methods be scrapped in favor of something new and different?

4. How do risk managers avoid inertia—resorting to old, familiar habits in making risk decisions; using familiar models and methods because they might have been helpful in past crises or situations? How do they avoid relying entirely on simpler cash-flow, “Ebitda” or debt-equity models because that’s what they know or because that was convention?

How do risk managers encourage flexibility in financial models without making them too complicated, too unwieldy or too hard to interpret and use? How do they encourage analysts or other decision-makers to use insight or creativity to employ new ratios or novel approaches—those that can capture hidden risks or project credit deterioration?

5. How frequently should models and methods be overhauled to incorporate new risks, pending financial regulation, new businesses models, and complex global corporate structures?

6. After the lessons of the crises, what aspects of credit analysis warrant more attention than they did before—Balance-sheet strength? Leverage? Liquidity? Corporate structures? Capital adequacy and cushion? And if they deserve more attention, how should models change to measure their importance or measure trends and deteriorating signals?

7. Do existing models and methods capture new risks, factors or variables that might have been overlooked or taken for granted before, e.g., complex corporate organization structures, intercompany capital and funds flows, or cash flow trapped in far-flung subsidiaries?

8. Do existing models and analysis sufficiently address how a client, borrower or counterparty withstands stress—from a sudden collapse in its business, in unexpected turns in financial markets, or in emergencies and unforeseen events and risks? Do they address vulnerability from flaws or unexpected weaknesses in cash flows, balance sheets, capital, and funding? Do they show or prove that the borrower is prepared for contingencies or unexpected risks?

9. What market-based models and indicators (those based on prices, trend or signals from trading markets, including bonds, equities and derivatives) should be used (a) to anticipate risks or sudden declines, (b) to measure the impact or weight of an oncoming crisis, (c) to determine if trends have reached a pivotal point? Which ones should be avoided? And what do they really tell us?

The Anchor: Ongoing Principles

If there are benefits to dynamic reassessments of credit models, then underlying principles should guide the process. Models and analysis shouldn’t be tweaked or overhauled just for the sake of it. There should be purpose and rationale.

1. Credit models, financial analysis and credit methodology should be tools for making risk decisions. They should guide and support the judgment that goes with decision-making.

2. They should be polished, detailed, and precise. They should encompass a variety of scenarios. While they should acknowledge and study the past, they should be forward-looking.

3. Credit models and analysis should be flexible and evolving to adapt to changing business conditions and new business models and industries.

4. They should provide benchmarks and standards to guide in decision-making, but are not substitutes for the synthesis and judgment necessary to make final decisions.

5. They should adapt immediately to changing clients, businesses, industries, and business and financial scenarios.

6. They should be rigorously assessed, regularly reviewed and updated for relevance, usefulness, and their ability to anticipate risks and declining scenarios.

Financial Analysis: How to Adapt?

To improve models and analysis, it’s not enough to introduce new ratios and dare to design and project cash flows from now until the next crisis. Analysts should thoroughly examine how models “behaved” or “performed” in the recent crisis.

Did they predict the decline of companies within an industry? Did ratios, trend analysis, profit-margin assessment or
balance-sheet reviews suggest how a company would perform during a downturn? Did analysts allow themselves to get lost behind a barrage of ratios, numbers, spreadsheets, and data, stifling their efforts to see risks? Did models suggest a downturn, but analysts, for various other reasons, ignored the signals? Or worst, did analysts merely shuffle the presentation of data to reach the decisions they wanted or substantiate previously made decisions?

For risk managers: Did they understand the kind, type and amount of credit exposure, and did they use the correct analytical approach to assess the counterparty/client? For example, should they have taken a long-term analytical view, if credit risk could potentially extend farther than initially thought? If a short-term loan could extend beyond one year, did they use the method or analysis that assesses long-term risk?

Over the past decade, because of new products and innovative extensions of credit, credit risks and credit exposures have become complicated. Credit risks may start as short-term exposures, but morph into something long-term. They can be contingent, quasi-guaranteed, and structurally subordinated. Or they may appear to be senior liabilities, but in a liquidation scenario, they get bogged down in a legal process that makes them appear subordinated or equity-like.

In one way, this past crisis was similar to other crises, when bank risk managers presumed they had approved short-term, collateralized, senior risks, but realized later, the exposures oddly transformed into long-term, unsecured risk.

Before Analysis: Understanding Exposures
Long before the risk decision and before the analysis or model examines the risk, risk managers are reminded to understand the risks, exposures, and products they oversee:

1. Lending risks, including loans, bonds, receivables, letters of credit
2. Counterparty-trading risks, including securities, currency and derivatives trading
3. Operating risks, including intraday processing, funds transfer and securities settlement

Within these categories, they must measure and classify these risks in their various forms:

1. Secured/unsecured exposures
2. Intraday/short-term/long-term exposures
3. Direct/indirect exposures
4. Contingent and conditional exposures
5. Committed and uncommitted exposures
6. Senior and subordinated exposures.

After classifying, understanding and measuring these risks and their forms, risk managers should prioritize them based on magnitude and risk tolerance before deciding what credit model, analysis or risk methodology is the right one to determine client/counterparty creditworthiness. They should ask, for example: If the exposure is contingent (probable), but long-term and unsecured, what is the right model to assess the exposure? If the exposure is short-term, collateralized, but substantial, what is the right credit methodology?

Risk managers must have well-understood guidelines to determine when it is appropriate to perform a thorough, in-depth analysis, and when it is appropriate to use market indicators or external ratings. They should be clear and consistent about what kind of analysis or model applies to one-, three- or five-year risk; or secured or unsecured exposure.

Risk Ratings: Message Updates
Internal ratings or grades of clients and borrowers have been an important risk tool for banks for a long time. They are usually derived from credit and financial analysis and from other factors (assessments of management, operations, and industry risks) and used to set standards or limits for risk categories, exposures, forms, and tenors.

In boom times, when business is brisk and there is a flurry of deals, transactions, and exposures, bank risk units sometimes fall behind in their efforts to rate borrowers and counterparties properly or sufficiently. They may rely on rapid, insufficient analysis or skip analysis altogether and rely on external sources (from ratings agencies or market indicators). Or they may use computer algorithms based on a borrower’s financial statistics, ratios and trends to determine a rating.

Risk grades and risk ratings continue to be useful tools to set risk parameters, limits, and guidelines. Ratings are communicators that send precise
messages bankwide about risk managers’ view of a company.

Problems with corporate borrowers or trading counterparties the last few years taught a few lessons. Ratings are useful when they are dynamic, reviewed constantly, react quickly to changing markets, and permit judgment and insight to set the final rating. Judgment and insight permit risk managers to be forward-looking, to examine worst-case scenarios, to assess the quality of quantitative analysis, and to determine whether a borrower can endure a downturn. External ratings or programmed ratings are useful guidelines to start the decision-making process, but not to end it.

Banks with hundreds or thousands of corporate counterparties scramble to keep up with ratings and collect new information to keep ratings current. Risk managers can handle this burden better if they pose the following questions regularly in a reflective, candid risk-rating review:

1. Will changing market conditions have impact on any counterparties, clients, industries, or industry segments? Is any client or industry subset vulnerable to changing conditions?

2. Are current risk-ratings appropriate for affected clients? Do we adjust the ratings now to reflect new risks? Is there any reason why a rating for a specific counterparty shouldn’t be changed now?

3. Are the criteria that apply to ratings up to date and encompass new factors and risks? Do the criteria evaluate how well a company is prepared for downturns?

Financial Information: More, More and More

Securing ample financial information and statements is the starting point for most credit analysis. The events over the past few years proved that more information is better, and more explanation and description of the information is best. Analysts should go beyond a simple transfer of statements in a data dump into financial models. From lessons of the past few years, they should:

1. Be wary of discrepancies, inconsistencies, and incomplete disclosures.

2. Ask questions and request detail and explanations to look for hidden risks—in, for example, foreign subsidiaries, special-purpose entities, shell affiliates, or non-strategic activities.

3. Appreciate the importance of footnotes, where often a truer, more complete story of the company’s business is told. In footnotes, an analyst can detect hidden risks in the form of contingent liabilities, accounting oddities, off-balance-sheet data, cumbersome subsidiary structures, and regulatory requirements.

4. Request more information. Audited statements may not include other invaluable information that is prepared and available, if requested. Supplementary information will show under-the-surface risks: inter-subsidiary transactions and funds flows, management’s long-term investments and strategies, tax treatments, and probable capital withdrawals.

Supplementary data can provide clues for what can go wrong or what might make the company vulnerable. Or they might show what doesn’t seem right or what appears inappropriate for the type of business it is involved in.

tracytroy4@aol.com
CLIENT RELATIONSHIP MANAGEMENT – REMEMBERING THE BASICS, EVEN IN A RECESSION

In this article Mark Andrews, Head of Banking and Finance at Risk Reward Limited reminds us that it in a recession it is all too easy to neglect the performing section of the customer base. Too much time spent trouble shooting and not enough on customer care could mean that this essential component of the business may be diminished to the extent that when the recovery eventually does come it will be much harder to achieve normality than it could be. A few basic customer care steps is all that is needed to make the task so much easier.

Probably the most enduring memory from my own bank training days, is a film by Video Arts, called “Remember Me – I am the Customer?” – first edition (1980’s). I vaguely remember an American wandering into various outlets experiencing the worst aspects of customer service, often being ignored. The film ended with the message “Remember me? Yes, I am the customer and I can walk away” as he did so.

Although most of the situations were extreme for training purposes, the film left me with the strong message that it is very easy to lose good clients by simply forgetting the basics. These start with the fact that you are only as good as your last client contact and end with the clear message that clients who are not served well will simply and quietly, go elsewhere.

This memory came back to me recently when I was talking to some clients about debt recovery and reconstruction. Their marketing and other senior executives were so busy fire-fighting problem cases that they had actually forgotten the basic rule of client relationship management (CRM) – look after your existing good clients or somebody else will! The 10% of problem cases were using up most of their time, leaving little or no opportunities to ensure the 90% of their client base, which was actually still performing, felt wanted.

The Current Challenge for Banking
Some surveys suggest that nearly 65% of clients who change banks do so because they feel that their custom is neither valued nor appreciated. The most frightening aspect of this statistic is that just like the man in the film, good clients do not tell you they are thinking about leaving, they just go. Given the high cost of acquisition of new customers, this can represent a significant loss of income.

Banks need to act promptly and prudently in a difficult financial market, such as that in which we are currently operating. Obviously in the short term, it is right and proper for recoveries management to prioritise the worst recovery cases above existing clients because that is where the major challenges exist.
However, in the medium and long term, preserving the core business so that when the recovery does come – and it will - the firm goes on to thrive, is vital. This means remembering, somehow, to take care of the most important resource after your staff – your customers.

As the fictitious customer in the film kept stressing, good clients rarely complain, they usually prefer to avoid making a fuss, and do not protest as they should when they feel ignored or undervalued. What they can and will do is leave you – eventually.

On average, unhappy clients will tell between 10 and 20 others just how poor they found your service. As an example of this potentially cumulative damage, try and recall the last time you asked a friend or colleague about a local restaurant only to be told “I have not been there myself, but I am told its poor”.

To address the problem, it would be natural for top management to use their best staff in the recovery process, especially those that have the best people skills. This usually means the marketing or CRM team. This would be the most effective approach in the early stages but it is easy to forget that client relationship experts are best engaged in protecting the client base and building new business. If they are left in recoveries for too long, they lose their entrepreneurial spirit and can become totally negative seeing problems or hidden dangers in every proposition even where none exist. “He who does nothing, does nothing wrong” is the way to create a reputation in a recession but it is almost useless once the recovery is over and growth is required.

Of course many firms see the whole area of recoveries as essentially a legally oriented process which does not deserve CRM skills leading to additional consequent losses.

Changing your Approach
So having identified the problem, what is the solution?

Well the first issue is how to deal with recoveries without using all of your CRM team’s resources in the process.

There are no hard and fast rules because each problem portfolio has a different composition but generally speaking, the small debts should be handed straight to a collection agency or specialist recoveries team after only one attempt by the CRM to reach an arrangement. It is not worth spending too much management time on relationships where it will not be cost effective.

For medium size debts, two “yellow cards” or chances may be appropriate for the account as the stakes are too high to give up at the first attempt. But after two goes, the accounts...
should ideally still be sent to the specialists and away from the CRM because in my experience, after two failures, the law of diminishing returns applies and you could be wasting the team’s skills.

For the large debts, where considerable amounts are at risk, CRM involvement is vital and should only be withdrawn when senior management feel there is no point in continuing the rescue efforts. This is a judgement call and it is not unusual or inappropriate to keep the CRM continually involved in these important cases. However, this logic must not apply to the whole portfolio and everything else should normally be switched away within a short period, especially if the negotiations are not making progress or promises made by the client are broken.

Having freed the CRM team from all but the most serious recovery cases, they can now be deployed to do what they do best - look after the client base and continue seeking new opportunities.

Looking after your customers

So how do we look after the client base to maintain its integrity?

To start with a negative, there is no place for sentimental or soppy contact such as “happy birthday” texts. You must keep in touch in a manner that is appropriate and avoids superficiality. Most clients will feel you are just going through the motions if you are not careful and I have heard of more than one client where the birthday date was actually wrong.

What must happen is that some type of normal business contact should take place regularly, with a minimum of half yearly intervals. A brief letter or e-mail for the smaller clients thanking them for their custom and offering to meet them to see if you can help with anything is fine.

For medium sized clients you may well write or e-mail offering a meeting, inviting them to do so if they wish. Sometimes a telephone call will suffice but remember that an unsolicited phone call can be seen by customers as annoying and counter productive. You do not want the contact to be a negative experience and in the UK there are even legal restrictions under Financial Promotions legislation.

For larger clients or anyone judged to be important, regular contact including meetings is essential unless the client declines. You should consider dropping by, calling briefly are simply e-mailing. But do remember an impromptu meeting or brief call should be just that, short, no more than 15-20 minutes unless the client wants you there longer - and do not attempt to sell. The purpose of the call is relationship building not sales – the client will approach you anyway during the contact for anything they need if you handle this well.

Whatever system you use, no client, however small, should be ignored or overlooked by you for longer than six months. By staying in touch in this way, you will make all your key clients feel special, appreciated and above all, unlikely to walk away.

Finally, one question I am always asked is how to manage the time available when the CRM is flat out and it seems to have no spare capacity. I have two answers. First every customer is entitled to the same degree of service and quality from you but they are not entitled to the same amount of your time. You must allocate resources to those areas where they are most likely to deliver the best dividend. If you do not or cannot do so, you are allowing your in-tray to manage you, it must be the other way round. If you are manager, you should be able to manage.

Secondly, and back to in-trays, if you are so busy that you cannot complete all the tasks allocated to you in a day, you must order your priorities by deciding who you can afford to disappoint and who you cannot. Try to let the unlucky clients know with a call or e-mail and keep them updated about progress. They may be disappointed, possibly, but not as angry as a client that is or feels ignored.

Managing the CRM Resources

In summary the CRM is an important and crucial part of the maintenance of credit relationships and needs to be carefully managed to ensure that you emerge from the crisis in the best possible state.

MCA@riskrewardlimited.com
These issues can most notably be seen in the leveraged loan market which had both grown exponentially and metamorphosised during the boom years driven in particular by Private Equity and the Institutional Investors. Indeed there has been very recent case law (HHY Luxembourg SARL and another v Barclays Bank plc and others) where the issue of structure was the key point (I will revert to this case later in this paper to illustrate the point of when a structure goes wrong).

A borrower can very often be a holding company, a sub-holding company or otherwise a specially created funding vehicle for a group. The reason for such structures can vary but might be due to geographical, legal, accounting, tax, business or other financial management considerations. The assets of such companies will mostly consist of equity held in subsidiaries and intercompany loans.

It should be noted that under English law each individual limited company (whether a private or a publicly quoted company) has its own independent legal status and will not be held to be responsible or legally liable for the liabilities of another company unless it has satisfied all of the following conditions: a) it has the power to commit the company to the

**ARE BANKS BUILDING UP A DEADLY PORTFOLIO OF UNDERPERFORMING LOANS?**

**PART 3 –**

**THE IMPORTANCE OF UNDERSTANDING DEBT STRUCTURES AND DOCUMENTARY POSITIONING**

The first two papers in this series covered the expectation of increasing levels of distressed debt in the market over the coming years together with a number of themes the players face when dealing with a restructuring. In this third paper in the series, banker Simon Ling-Locke, MBA, FCIB, DipFS Director of Credit Risk Services at Risk Reward Limited, looks at the importance of appreciating debt structures and the documentation used, particularly over the last few years, to highlight some of the areas of increased complexity and, as a result of that, the increased risks parties are likely to face due to potential misunderstandings of rights and powers of different lenders.
liabilities of another, b) the commitment has been authorised, correctly approved under its internal articles of association and actually given, and c) the laws of the country in which the company is incorporated also so allow that extension of liability. Without such liability being extended the ‘corporate veil’ will prevent a lender or group of lenders from being able to claim against the assets of anything other than those of the borrower itself which could be little more than the shares held in subsidiary companies (equals equity risk) and (usually on an unsecured basis) loans provided by the holding company to its subsidiary (and potentially ranking behind other creditors).

Lenders therefore have to be focused on the structure of a group i) at signing and ii) how that structure over time as that structure could change which might impact on where the real assets of the group sit. So, how might a lender gain the seniority it wants and achieve the desire of having priority to the assets of a group over say second lien lenders, mezzanine lenders, high-yield bond investors or indeed vendor loan note providers or general unsecured trade creditors? And what about the rights of other players such as hedge providers?

Group structures where there are a variety of interested players, assuming they hold differing rights over assets, might seem of little concern while a borrower is fully performing but it does become a real worry when a group slips down the demise curve and the parties discover that the value of the group breaks below the equity and into the debt (i.e. the remaining estimated value of the assets of a group is less than the equity meaning that not all of the lenders will achieve a full recovery). Junior lenders in this situation will be focusing extremely carefully on where that assumed value break falls and will be analysing whether they can enhance their recoveries due to documentation or structural inequalities which might potentially give them higher rights and better recoveries. Indeed the ‘value break’ is a very significant area of controversy and difficulty in a restructuring but this paper will not explore the intricacies around company valuation except to note that there has been fairly recent case law in England on this issue (IMO Car Wash in 2009) where the judge, Justice Mann, set a precedent by throwing out the junior lenders’ argument for the use of forward valuation techniques (which based on two more creditors assumptions indicated higher recovery rates) in favour of the use of more predictable valuations now. This precedent for English courts, and hence much of the leveraged loan market in Europe (as primarily governed by English law) could potentially result in a different outcome to those in the USA where the US courts have appeared to be more open to considering forward valuation approaches.

These creditors who have some but not full economic interest are known as the ‘fulcrum lenders’. They are likely to impose the most pressure and tension into the situation to try to maximise their own returns. As such, this is when the parties create additional complexity in a restructuring since not only will there be need to focus on operational restructuring and the overall potential supportable debt load but also on how the value is apportioned between the parties whether that be through an eventual consensual restructuring or through a court driven process.

So, coming back to my earlier question of how priority of some lenders over the rights of others is achieved. Certain lenders can take security (fixed and floating charges in England) but if the borrower is a holding company what are those charges actually over? It is likely to be primarily shares in subsidiary companies and hence equal to an equity investment ranking behind all creditors in that subsidiary and/or a charge over an inter-company loan. But has that inter-company lending been properly documented with contractual terms and repayment obligations?

Quite often lenders discover that the inter-company lending has not even been formally documented! That can prove problematic if the debt has to be proved with a liquidator. However, there is a further hurdle to consider in that under the laws of some countries (this can happen in countries such as Germany and Spain to name just two important markets). Therefore, other ways of achieving priority of some parties and subordination of others are needed. The subsidiaries might well be required to provide upstream guarantees and possibly security as well to strengthen the position of the lenders to a holding company.

As with intercompany lending, the status and validity of such guarantees has to be considered since not all subsidiaries will have the legal power to provide a guarantee and/or security (the laws in some countries are more restrictive than in others). The other methods, which are likely to be used in conjunction with the above steps, to achieve priority rights revolve around contractual subordination and structural subordination.

Under contractual subordination, the lenders set out their respective rights in an intercreditor agreement. This is a written contract which is signed by or on behalf of each party refer to in the agreement (and which will also bind any secondary buyers of that debt) but will not bind any other lending facilities which have not been included in the intercreditor agreement. Until the breach of a loan covenant, representation or event of default or actual non-payment, the intercreditor agreement effectively lies dormant with the borrower having full control over its cash distributions to
creditors but as soon as a default has occurred then the intercreditor agreement comes into operation with a pre-agreed waterfall of funds coming into effect. This arrangement will result in one creditor not being paid by the debtor until another creditor of that debtor has recovered its debt in full or until amended terms have been agreed by all the parties. During any negotiation period it is usual to see stop notices and standstill periods being imposed on the junior tiers of lenders which stops payments of interest and principal and prevents them from commencing legal proceedings against the borrower to recover their debts for a period of time (the terms of the specific intercreditor agreement would need to be viewed to understand the exact rights in any particular case). Such arrangements are used especially in Europe to provide breathing space whilst creditors and the borrowing group try to find a consensual restructuring plan. This can be different to the situation in the USA where heavier reliance is placed on the formal procedures of organisations going through the Chapter 11 recovery process of their bankruptcy code.

Case Study:

HHY Luxembourg SARL (the European Directories Group of companies) was a leveraged deal involving a hierarchy of lenders with their respective rights governed by way of an intercreditor agreement. The group had been struggling under a very heavy debt load and had a pressing requirement to restructure this debt which stood in excess of Euro 2 billion. Restructurings are at the best of times fraught as some or indeed all of the parties face losing a portion of their claims or other rights. Thus in any consensual restructuring the first issue which has to be addressed and agreed upon is to establish where the value breaks amongst the parties. The second key issue is determining whether junior parties who are ‘out-of-the-money’ based on the value break can be excluded from the ‘consensual restructuring’ or whether they have some form of negotiating strength which could thwart or otherwise cause the more senior ‘in-the-money’ creditors to amend their proposed restructuring to include the junior creditors in some way. Junior creditors are therefore likely to be searching for loopholes in the structure or in the documentation which governs the various rights of lenders to find if there are ambiguities which could give them this negotiating leverage against more senior in-the-money creditors. Indeed this was the crux of the case of HHY Luxembourg SARL and another v Barclays Bank plc and others.

Namely, when enforcing at the holding company level did the senior lenders have the ability to see that the operating companies could be sold free and clear of any security, debt and guarantee claims held by any junior creditors over the shares in those operating companies and their subsidiaries against the wishes of such junior creditors? The rights of the various lenders to the group were governed by an intercreditor agreement and so the construction of the provisions in that agreement were crucial in deciding whether or not senior lenders did have such rights. The junior creditors focused on the meaning of the words “Obligor or any holding company” in the agreement (the standard loan agreement definition of an obligor is ‘a borrower or a guarantor’). The judge in this case acknowledged the court had been choosing between unnatural and competing meanings but in the end determined that the meaning of this reference only covered the Obligor or a holding company whose shares were to be disposed of and not to other companies, i.e. subsidiaries of an Obligor whose shares were being disposed of. Thus the junior creditors had been able to persuade the judge that the intercreditor agreement provided for only ‘one layer of release’, i.e. the release of the liabilities of the Obligor itself where its shares were to be sold but not of the liabilities of its subsidiaries.
Contractual subordination achieves its intention so long as:

a) the intercreditor agreement has been clearly worded without ambiguity and unfortunately with no one standard document in the market the risk of error is always possible as can be noted from the case study I explain in the box opposite;

b) there is restriction on operating companies from being able to raise finance or provide guarantees to ensure that external debt raising is controlled;

c) there is control over which subsidiaries can receive intercompany loans;

d) there is control over the group structure to ensure that growth in areas of the group which are not part of the security and guarantee package are brought into those arrangements (bearing in mind that there could be legal restrictions under the laws of the local country).

Structural subordination, on the other hand, uses the basic premise of the corporate veil, i.e. one company is not liable for the debts of another unless it has so agreed to by contractual means and secondly has the power to so commit by contractual means. Thus, lenders providing secured debt to a holding company level, where the borrower then uses all of the proceeds to acquire shares in another company and has no other assets, will merely have security over equity which would rank behind all the creditors of that subsidiary unless a contractual arrangement had been put in place with that subsidiary company and its lenders to alter the common law structure (i.e. guarantee and intercreditor agreement). It is perhaps therefore not surprising when one considers the number of different companies in group structures, especially in the leverage market, that contractual subordination can be thwarted by unforeseen structural issues. This can be seen in the very recent case of HHY Luxembourg SARL and another v Barclays Bank plc and others.

In terms of take-aways from this case and intercreditor agreements in general, the following comments can be made:

- It would appear that the courts will base the intention of the parties upon the wording of the clause and will be unlikely to enlarge on the wording of the clause unless there is very significant ambiguity. Where there is ambiguity, the intent of the clause will be in accordance with the reasonable interpretation by a commercial person of the wording of the clause which might well not be what that clause was originally intended to have achieved.

- Intercreditor agreements, signed at the start of a lending package, effectively lie dormant whilst a company is performing and only become relevant when something has gone wrong. Thus for many lenders the dye is already cast since it will be only for newly created intercreditor agreements where lawyers will be able to clarify wording beyond doubt (I can hardly imagine junior lenders willingly giving up that benefit where they have it now unless some valuable benefit is given to them in return!).

- Therefore for newly created lending facilities where intercreditor agreements are required, absolute clarity in that agreement will be essential to prove the intention of the junior lenders to have given up or excluded their legal rights over guarantees from subsidiaries.

- Lenders need to look carefully at intercreditor agreements to understand how the wording applies in their agreement and the implications for rights of differing parties. It is important to remember that there is no one standard form intercreditor agreement and that each is tailored to the particular transaction (note: since 2008 the Loan Market Association has produced a ‘recommended form’ intercreditor agreement but this is not equivalent to a ‘standard’ form as various terms will still be tailored deal by deal).

Thus the ‘value break’, ‘documentation rights’ and ‘structural subordination’ are perhaps the most important financial factors which have to be considered and resolved when dealing with a restructuring where there are differing layers of creditors. For both creditors and advisers clarity across these issues helps to determine:

1. the differing rights which lead to differing levels of negotiating leverage;
2. the process (through a consensual out of court settlement or otherwise through liquidation or court enforcement); and
3. an optimal restructuring solution based on the particular circumstances of the case.

SLL@riskrewardlimited.com
YES, YOU HAVE A BUSINESS CONTINUITY PLAN …. BUT WILL IT WORK?

Paul Kilduff B.Comm FCA, Business Continuity Planning consultant at Risk Reward Limited, summarises the key components of a successful Business Continuity Plan which are required to ensure your financial organisation can survive a disaster.

Paul Kilduff B.Comm FCA is a banker with 20 years experience in internal audit, operational risk and operations management. He is a former Vice President of Operational Risk with Merrill Lynch and a Risk Reward Business Continuity Planning consultant. With an increasing number of external threats to business organisations, he provides guidance here on whether your own recovery plan will work.

There are enough types of disasters in the world today – hurricanes, floods, fires, terrorism, sabotage, pandemics, riots, ash – without your Business Continuity Plan being added to the list. Many organisations today have recovery plans in place but few plans have ever been invoked in anger. And these threats to business are on the increase with examples such as riots in Athens, extreme weather conditions across the globe and further terrorist related incidents.

A Business Continuity Plan (BCP) is a holistic management process that identifies potential impacts that threaten an organisation and provides a framework for building resilience with the capability for an effective response that safeguards the interests of its key stakeholders, reputation, brand and value-creating activities.

Essentially, a BCP is about making proactive and reactive plans to help your organisation survive crises and disasters and thus being able to quickly return to ‘business as usual’ should they occur. Otherwise your organisation may perish. BCP is essential to banks and other financial institutions where customers demand reliable and timely service and failure often comes with a large cost.

Here are ten easy yet essential topics to address when evaluating the effectiveness and completeness of your own business continuity plan:

I. The Plan – do you have a BCP? I don’t mean that people know what to do in the event of a crisis but is there a documented plan in place in the organisation? Where do you keep your plan? Is it in your desk drawer and just in case you also keep a copy on your office PC. That’s not enough.

Take a hard copy home and keep it safe. If you drive to work then keep a hard copy in your car. Or save a copy to a memory stick and add it to your key ring in order to be able to retrieve the plan at any PC. But remember at all times that the BCP is confidential and it should be kept safely.

Is your plan too light at 5 pages or is it unusable at 100 pages plus? Do you have many diverse individual departmental or business unit plans? A single company –wide plan is preferable.
2. Accountability – Is your BCP important enough (and it should be) to have been formally approved by the CEO and/or Chairman? Did you present it to the Board of Directors in person and were they impressed with its relevant and comprehensive nature? Are the top management in your organisation as engaged with BCP as they are with market risk, credit risk or operational risk? They should be, since a serious BCP incident presents as much threat as any rogue trader or bad debt.

One of the biggest causes of weak BCP is a lack of commitment from senior management. Is your BCP process owned by some middle ranking operations manager or by someone more senior?

Did you offer your BCP to your internal audit department and ask them for an honest opinion?

3. Crisis Management Team – Only the Crisis Management Team (CMT) should be able to activate the BCP. Do you know who is in the CMT, how they will do so and who will lead the team in a crisis? The CMT should include all the heads of the key functions – it should include the most important people in the organisation. If one of the CMT is away as is bound to occur when disaster strikes, do you have nominated alternates for each member?

4. Command Centre – Do you know where the CMT will meet? It is best to select a few locations to suit possible different circumstances – include a room in head office, a room in a nearby hotel and a room far away or a room in the recovery site. Do you know where the CMT will get key resources such as laptops? Do you have a checklist of the first tasks to be performed by the CMT?

Have you conducted training for the CMT, such as notification training (an assembly of the team to ensure that they know where to go), table-top training (a pre-scheduled gathering conducted as a brainstorming meeting), or simulation training (a realistic disaster scenario played out for their benefit which evolves courtesy of an expert facilitator).

5. Recovery Site – Have you agreed the location of your recovery site? Is it a ‘hot site’ where your systems and facilities are ready for staff to walk in anytime and sit down to work or is it a ‘warm site’ where a few hours of work will be required to activate systems and processes before staff arrive?

Are too many people going to the recovery site? Why not give them a laptop to use at home now?

Will you have enough space for your needs and have you got confirmation in writing that no other organisations in your vicinity will use any shared facilities in the event of a local disaster. Do staff know where the recovery site is located and have they visited the site to ensure their familiarity? Is the recovery site too near your office to suffer collateral damage or is it too far way to reach easily?

Will staff even reach the recovery site? Remember the example of a bank in a London suburb whose plan was to ask staff to drive their cars to the recovery site, only to learn that in a real invocation due to a power outage, the electronic gates and barriers in the banks car park were firmly locked shut.

If your recovery plan involves flying staff to other locations in Europe, have you updated your plan in the event that, once again, European airspace is closed for six days due to volcanic ash clouds?

6. Awareness – You have a BCP but is it one of those ‘secret’ plans that are only known to the CEO, the Board of Directors, management and those who co-ordinate BCP? Do the other staff who will relocate to alternate locations know about the plan? Have you held staff briefings for all the staff annually, have you designed and mandated online BCP courses for staff, do you have a BCP intranet web page containing all relevant BCP information and is BCP on the agenda of staff meetings?

When you invoke your BCP will the telephone call tree used to contact your staff be up to date so that everyone can be reached? Or do you have a toll-free number or an internet page ready to be updated with the latest information for staff once they enter their login and password details? Few things matter as much in the event of a disaster as the ability to communicate to your staff.

7. Testing – Having a BCP and not testing it regularly is like confidently driving your car knowing that you have a spare tyre in case of an emergency, only to find that when you have a blow out that the spare tyre hasn’t been tested for years and is deflated. BCP should be tested.
annually and the critical elements should be tested semi-annually. An untested BCP is almost worthless.

The only constant in business is change itself so when was the last time your BCP was tested? Did you postpone the scheduled test for another few months because one department was ‘too busy’?

Testing is only worthwhile if test failures are identified and resolved in a timely manner. Are you still doing basic simulation and parallel testing when it’s really time to do a full interruption test? The most mature BCP-ready organisations dare to test in an unannounced manner. Remember that there are only three things that matter in BCP – have a plan, test it and resolve any test failures.

8. Media Communications – When disaster strikes you will be inundated with media requests for information. Do not follow the example of BP after the Gulf of Mexico oil spill and allow your CEO to do unscripted gaffe-ridden interviews with TV crews. Instead, prepare standard scripts in advance to cover different scenarios and include these as Appendices in your BCP.

Nominate one experienced communications person to speak to the media. Everyone else in the company should be told not to conduct interviews. Only bring your CEO out to face the press when he/she is fully briefed and prepared.

Remember the Commandments of Crisis Communications – Thou Shall Not Say ‘No Comment’, meet the storm head on, do not speak off the record, do not hide from media but do repeat the message.

9. Enterprise-wide BCP. This is not jargon but it is the policy driven requirement that the business continuity plan exists to support or otherwise safeguard every employee in every company location in the world regardless of organisational alignment or functional role of the individual. Recall the corporate motto of Tesco which applies equally well to BCP – ‘Everything, everyone, everywhere.’

Does your BCP cover all locations, all offices, all legal entities, all systems applications, all hardware, all business processes, all vendors, all people? Remember that out of sight is out of mind so don’t forget to include that lesser known building located well away from your main city centre office.

Enterprise-wide BCP also requires consistency across the organisation and requires that BCP is co-ordinated by a single Unit or a single Manager with enough staff, a budget and a high profile.

10. Certification – If you have answered all the prior questions satisfactorily then target the ultimate industry accolade. The British Standards Institute will certify your BCP if you meet the specifications of their BS 25999 standard. They will perform a remote desk-top review of your BCP and later their assessor will visit your offices to complete the certification process, and all for a reasonable fee.

The benefits of BSI certification are many – clients will be impressed, it provides a useful benchmarking exercise, it improves compliance with best practice and it is a competitive edge when it comes to tenders or service level agreements.

In conclusion, the effectiveness of business continuity planning depends upon the involvement of the board and senior management and it requires a continuous, process-oriented approach that includes comprehensive planning and testing. BCP should be developed on an enterprise-wide basis and the effectiveness of the BCP must be validated through at least annual testing. The BCP and test programme should be updated to reflect and respond to any changes in the organisation.

Only then can an organisation stare down disaster with confidence.

PWK@riskrewardlimited.com

YES, YOU HAVE A BUSINESS CONTINUITY PLAN … BUT WILL IT WORK? CONTINUED

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PWK@riskrewardlimited.com
CENTRAL COUNTERPARTIES FOR DERIVATIVES – MYTH OR REALITY

Dennis Cox is the Chief Executive of Risk Reward Limited and chairs the Chartered Institute of Securities and Investment Risk Forum based in London. In this article he considers the likely impact of the development of OTC central counterparties and clearing facilities.

Why the Determination for Change?
There appears to be a commonly held view that credit derivatives, themselves over the counter products, were at the heart of the crisis and that they therefore need to be reined in. There is actually very little evidence to support this conjecture – yet it is widely believed. Indeed I am of the opinion that derivatives were actually part of the solution rather than part of the problem.

The view is recognised that the size of the derivatives markets is much larger than the underlying market and that they can distort trading patterns. If the concern was that there were large undisclosed transactions being conducted then the clamour should have been for post trade reporting, rather than for clearing systems to develop. The over the counter derivative operates with the legal certainty resulting from the great work conducted by the International Swap Dealers Association. It involves professional counterparties who utilise these instruments for a range of purposes, only one of which is speculation.

However a scapegoat was sought and derivatives do make a possible scapegoat. They are hard to value, potentially very large and powerful, whilst currently not transparent at all. Their complexity makes them an easy target for the public and the politicians since few understand them. In the need to be seen to do something the over the counter derivatives market was an easy target.

What is Likely to Happen?
There can be no doubt that central counterparties and exchanges will develop and that there will be increasing pressure for over the counter transactions to move to such exchanges. Regulators will use various means of persuasion, including capital charges, to ensure that this happens. The exchanges will develop – and then they will slowly decline and merge. This will waste significant sums of money and will result in a reduction in risk management hedging being undertaken for true business purposes.

There is already a well established derivatives trading market on exchange – the exchange traded derivatives market. There has never been a barrier to these exchanges developing new products which could be standardised and meet with customer demand. That no such instruments have been successfully launched leads to part of the problem. The demand will be to develop a series of standard contracts to launch on the exchanges. These will need to achieve general acceptance and volume to be successful which few are likely to achieve. Over the counter derivatives are bespoke transactions which are designed between the two counterparties and are able to meet specific needs.

Standardisation will remove much of the volume and result in many of the transactions failing.

Exchange traded derivatives operate through the market participants placing margin with the exchange to cover the risk of the transaction for its open period – normally one day. Since over the counter contracts for difference by their nature cannot achieve this there will need to be a longer time period for the margin to address. If the proposals currently being discussed actually come to fruition then this is likely to be at quite a high confidence level and will therefore be considerably higher than the levels of margin that market participants have become used to.

This major debate will run for a while but my expectation is that the level of margin required to provide adequate protection to the exchange will undermine the cost effectiveness of the instrument.

Next is the mark to market problem. In exchange traded derivatives the market participants typically transfer or receive daily margin from the exchange. In over the counter markets counterparty credit risk management is applied through the operation of collateral management accounts to reduce the incidence of payments. Indeed for many over the counter derivatives the only actual payment is at the expiry of the instrument.

Standardisation of course runs directly into the accounting rules for hedging to be permitted for accounting purposes. The requirement is for a hedge to be near perfect – an 80-120 hedge. Many standardised contracts will fail to achieve this.

Then there is the final problem. For every contract for difference a solution can be designed which achieves the risk management objectives without any requirement for margin. So in fact the risk management transactions are unlikely to transfer to the exchange and will either be replaced by other products or will not take place at all.

Of course you would not expect us to explain in this article exactly how to replace your over the counter derivative transactions, but it will be important for all firms to think through their options and solutions rather than just rushing towards a solution which will not work or be effective.

The post trade reporting solution makes so much more sense. It provides the transparency that is sought without damaging a part of the industry which does not actually need to have either volume or capital extracted from it.

DWC@riskrewardlimited.com