

# After the financial crisis: Coming to terms with OTC derivative risk

In the fourth annual derivatives survey conducted by Navigant in conjunction with *Global Investor/ISF*, we find confidence returning to the derivatives market but also changes in usage driven by the importance of addressing risk for investors, firms and the market ecosystem

In the fourth annual survey, the market circumstances are again very different to previous years however the most recent results complete an important aspect in an evolutionary cycle. Selective adoption that grew into investment style must-have then became performance pariah has now given way to a new reality: a more balanced appreciation of the potential and risk of OTC derivatives along with a change of role from engine of investment performance to component part. They are essential to managing investment risk and have gained widespread adoption as efficient portfolio management tools. Although regulators and many investors continue to be wary, they are a permanent feature of the investment landscape.

Compared with the survey findings in 2009, which reflected the aftermath of the financial crisis and the fallout from complex instruments, OTC derivative volumes are up in what appears to be a sustainable appetite: increased usage driven by greatly increased buy-side understanding and continued progress on resolution of operational issues.

Using the survey results and drawing on the roundtable discussion, this article reviews emerging trends and highlights how the market is adapting to the new reality. We begin with demand, looking at what has changed and why: how investment offerings have been adapted to keep end investors on side. Next we look at how derivative operations have changed to better manage a firm's operational risk. We conclude with changes taking place in the

market ecosystem driven by the Regulator's aim to improve resilience.

## Keeping end-investors on-side: the influence on OTC demand

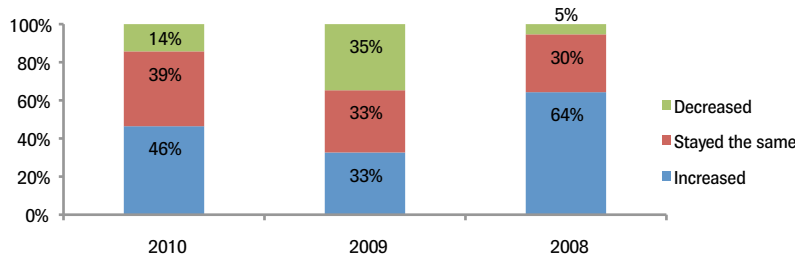
Figure 1 illustrates how demand has changed over the last 12 months and signals an overall hedge fund-led increase in the appetite for OTC products. Confidence is the principal motor of this growth; as John Read of Northern Trust observes: 'in the hedge fund space returns have been stronger over the last eight or nine months, so that's bringing confidence back.' John Haywood from J.P. Morgan Asset Management agreed, stressing the contribution made by hedge funds: 'It's the hedge funds that are really driving the volume increase uncovered by the survey. OTC derivatives are these managers' bread and butter; they are normally very quick to react to markets and make investment decisions generally quicker than traditional managers.'

Figure 2, which illustrates the shift in investment strategies (in response to end-investor appetite), adds a bit of "colour" to the demand picture. Equity long/short, absolute return and hedging overlay are the growth leaders. Fund of hedge funds, managed futures and market neutral are the growth laggards. Distress debt and 130/30 have seen a reversal of fortune compared with previous surveys.

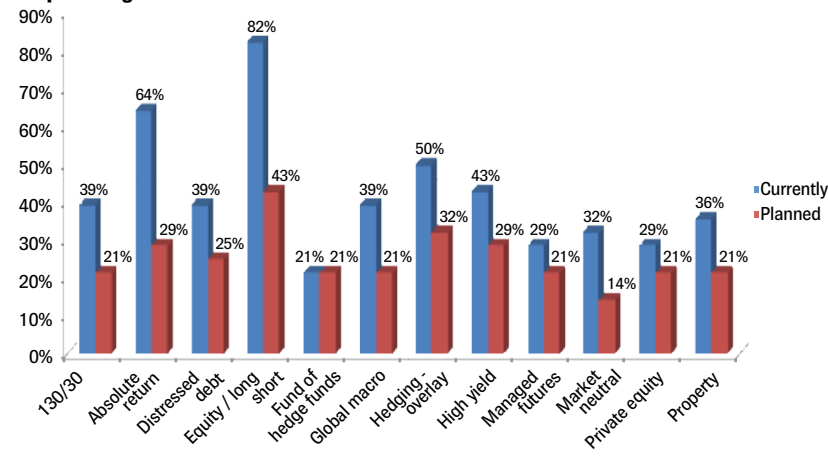
These results seem to be explained by end-investor balancing continuing demand for enhanced return (particularly in the current low yield environment) on the one hand with more careful allocation of risk budgets on the other. Understandable strategies are favoured and there continues to be a wariness of complex strategies and complex/opaque OTC derivatives.

Mireille Dyrberg from Trioptima described how the market has evolved: 'During 2008 many smaller organisations wanted to get away from having large

Figure 1: Has the number of derivative contracts you trade increased, decreased or stayed the same over the last 12 months?



**Figure 2: Which Alternative Investment strategies do you currently offer / are planning to offer?**



exposures to complex derivatives, and set up strategies for getting out of their large complex portfolios. Then throughout 2009 the focus was very much on vanilla instruments – using these for hedging purposes – with a major decrease in use of the more complex instruments.

However, headline growth is not the whole story. Within this overall growth, OTC derivative usage among traditional managers reduced or stayed the same. Hedge funds and traditional managers responded differently to the financial crisis and the risk “challenge” posed by it.

In addition to reallocating across investment strategies, end-investors reallocated with the type of firm and its core competency in mind. Traditional managers previously embarked on the convergence with hedge fund like strategies that found end-investor confidence wanting, retreated into more familiar uses of derivatives: risk management and efficient portfolio management. Buying rather than building became the preferred approach to close the capability gap to service convergence products like hedge fund UCITS. Read described some of this activity: ‘We are seeing some tentative expansion in the use of UCITS funds. Particularly in the UK, traditional asset management firms are buying hedge funds: whereas before they tried to develop the expertise in house, now they’re buying the company, the staff, and the software.’

Convergence or divergence apart, there was also a sense from the survey that the historic asymmetry between sell side and buy side derivatives expertise is starting to disappear. Ironically, the upheaval in the investment banking and hedge fund world over the last few years has benefited the buy side, a point made by Read: ‘the change is in the transportability of the resource: traditionally the quantitative

traders would have worked on the sell side fronting the institutions; now they have moved into hedge funds or the more traditional asset management space.’

The other notable shift in demand is the (almost certainly permanent) move away from complex OTC instruments. Philip Pople from Bank of New York Mellon explained: ‘We’re seeing a focus on the vanilla products not just for hedging but also for overlay - plugging the gaps, via standard OTC products, that the standard investment classes leave. This entails the buy side understanding more about what they are investing in.’ Dyrberg concurred, saying that ‘Buy side firms are educating themselves this year. For example, buy side institutions have the ISDA working groups. This is changing how these groups’ policies and commitment letters are being shaped, since they’re now receiving input from non-dealers.’

Rachid Lassoud from Bloomberg was keen to emphasize the flexibility and utility offered by vanilla instruments given some of the bad press the industry has attracted over the last few years: ‘The origin of the crisis remains in the highly complex credit instruments whose underlying elements were also highly complex. We need to redefine what we mean by complex derivatives: equity derivatives, interest rate derivatives and commodity derivatives are still widely used and are broadly mastered - these were not the origin of the crisis.’

### **Better managing OTC operational risk: joined-up processing**

The survey has shown over the last few years a steadily increasing trend towards outsourcing. Although last year we concluded that a single end to end solution across instrument types was still some years away, this year the drive to outsource

specialist services has continued apace with risk management a key driver. Figure 3 shows significant change in demand for services with a large increase in Managers looking to leverage external expertise in risk management, reconciliation and collateral management.

The survey suggests that this trend is strongest among large and medium sized traditional operations in the UK while institutions in the US are more cautious. Read, looking from the provider’s perspective, spoke about large increase in outsourcing witnessed since 2008: ‘I think most of what we are providing clients is a fundamental risk management offering. 18 months ago at Northern Trust I found 60% of active collateral management clients using our independent valuation service for their margin movements and 40% were still using a broker price or a counterparty price. Now it’s around 97% using the independent valuation.’

The outsource experience would also appear to be a positive one for managers, with none considering that outsourcing had been a bad thing. Some interesting contradictions emerge, however. While the hedge fund sector displayed the lowest uptake of such services, UK hedge fund managers from their positive assessment seem to benefit most from the services. While larger, traditional managers have outsourced more, they report their experience with greater ambivalence.

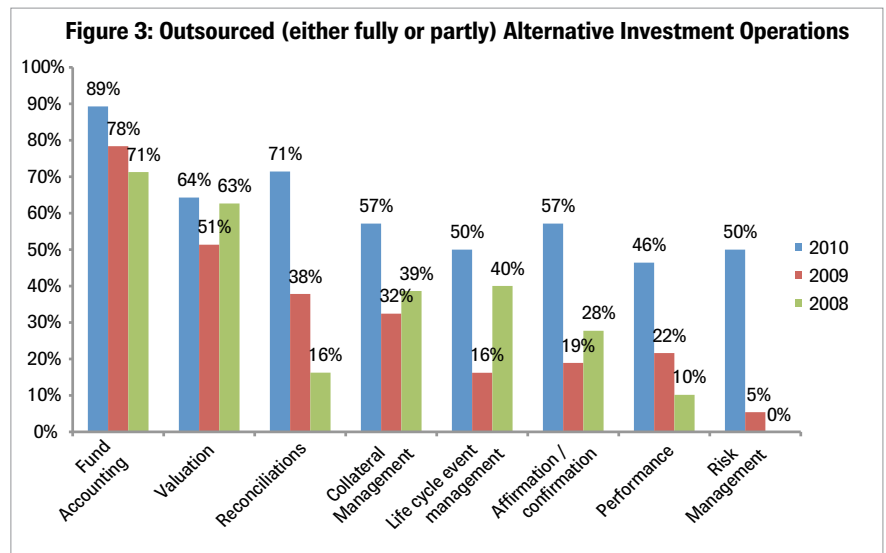
Operationally, and from the service provider’s perspective this component-based approach raises a number of challenges, not least the need to build flexible solutions. Pople observed: ‘the service providers have to be flexible enough to take some components and not others, and be able to substitute the customer’s input with what they would generate themselves.’ Dyrberg continued: ‘Whether institutions choose to outsource the whole front-to-back process or whether they have part still in house, interoperability is crucial. Standardised messaging is essential to this: it’s not just the service providers who are focusing on this, it’s also the dealers. Collateral management is a good example because it is the part of the operational chain that has the lowest STP levels. Historically it has used emails and someone keying the contents into SWIFT to make the payment. Clearly that is fraught with operational risk and prone to error. I think that is where the huge shift is going to be in the next 18 months.’

This approach also requires clear understanding between the different parties of key areas of responsibility and robust SLAs. The perceived issue around loss of control remains a key reason for

not outsourcing, as highlighted by a third of respondents. Haywood re-iterated the importance of a 'clearly laid out process in the agreement with the client. The client is responsible for what outsourcing providers are delivering but it's not the case that in every situation they must be involved with resolution.'

Of the key operational issues cited by managers last year, reconciliation and valuation would appear to have made significant progress. It is encouraging that this year we have found a marked increase in the use of third party administrators and market data vendors to value investment portfolios, signaling a move away from using the counterparty, of internal spreadsheet models. With over two-thirds of managers reporting outsource of this function in 2009, the figure this year has increased to 90%.

There are a number of reasons for this. Firstly, Haywood suggests that 'whereas before this was done in order to satisfy auditors, investors and even regulators, now it is to evidence due diligence around the valuation being used for NAV purposes.' Secondly, Dyrberg reflected that sell-side valuations were increasingly seen as not being acceptable: 'some institutions who did not engage in many of these areas previously have now decided that they must. But there has been an uptake in specialist services, it's true. In 2008 to 2009, the buy side realised that using your broker's valuation was not the best way to manage risk, so last year we saw a big move towards getting engaged with third party providers for valuations.' She went on to note that buy-side institutions were buying valuation services in growing numbers: 'We've seen a substantial growth presented to us in the CSA trades for the buy side, and we're also seeing the buy side come to our platform to reconcile their trades.' Finally, Popple suggested that greater client involvement was a factor. 'Despite a centralisation of the collateral function away from the asset managers, customers still want to oversee what you're doing, meaning more reporting on the valuations, collateral management, and reconciliation. They don't want necessarily to get involved with it, but they want to



see what's going on.'

**Improving market resilience: responding to the Regulator's agenda**

The survey results this year clearly show that market, regulatory and counterparty risks loom large in the thoughts of managers, and that focus on improving transparency around these risks has continued apace over the last year. Whilst in 2009 regulatory risk was not high on the agenda, the evolving Europe-wide drive for reform is clearly moving to the forefront of manager's minds. Figure 4 summarises the salience of risk categories across the industry, and highlights an acceptance by respondents that much work is still required to resolve challenges around operational, counterparty and market risk in the current global environment.

The key question is what initiatives or other structural changes institutions are implementing to better manage market, credit and operational risk?

The group looked at the role derivatives have played in dealing with the general market challenges and volatility abundant since 2008. Popple observed that 'On the buy side, the risk management function has assumed greater power.' He was of the opinion that continued use of derivative platforms amongst larger institutions 'is

obviously managing currency exposure with the high volatility that the markets are seeing here at present. And that is dictating to investment decision makers what they can invest in; they realise they must understand the back office functions and the post-trade activities, such as collateral valuation and management.'

Read agreed that 'There is a lot more rebalancing going on related to hedging, particularly around FX. Over the course of the last 18 months we've seen demand to build capability in that space, but again it's much more driven by the risk oversight of the portfolio and the closer governance and scrutiny over the process of rebalancing.'

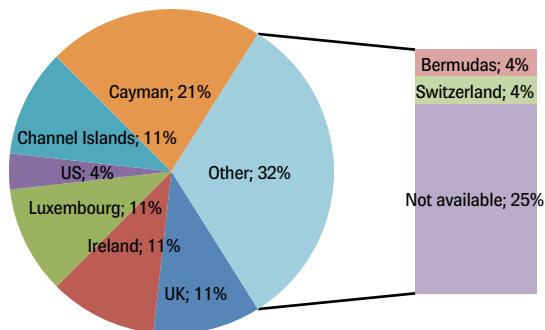
While firms are outsourcing more risk functionality than in past years, challenges remain. Lassoud made the point that consistency among products was a serious problem. 'Whether you have a valuation system or a risk management system, you need to have a consistent description of the derivatives. From a risk management side the first mantra is to make sure that you get a consistent description or a presentation of the product itself. Having the same description means adopting the same format; this is why FEMM was pushed by ISDA. But still there are some technical issues about being able to implement that framework for buy side firms because there is a huge IT cost in preparing your system'

Although respondents cited regulatory risk as of key concern, the survey hinted that little focus had actually been given to this area over the last year. While managers are keenly watching to see how the proposed regulatory tightening will impact the sector, the survey suggests that regulation has had limited impact so far. The reporting of OTC derivatives positions seems to have had greatest impact, while concerns most cited in the survey

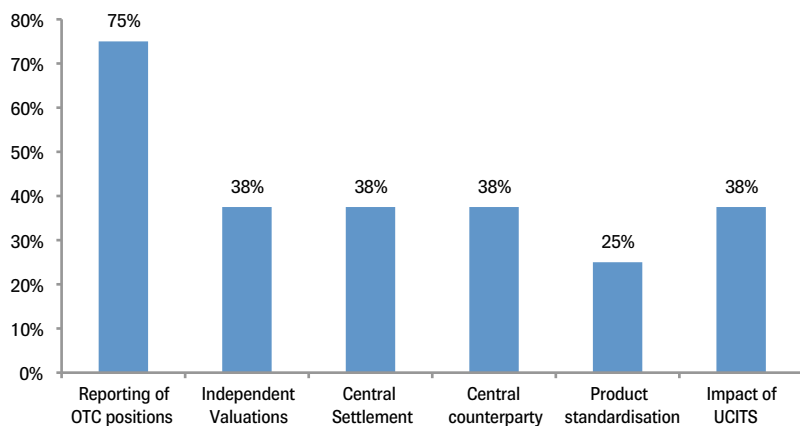
FIGURE 4

| # | BIGGEST RISK AREAS | RISK AREAS WHERE MONITORING HAS BEEN IMPROVED | RISK AREAS WHERE MONITORING IS PLANNED TO BE IMPROVED |
|---|--------------------|---|---|
| 1 | Market risk        | Counterparty risk                             | Counterparty risk                                     |
| 2 | Regulatory risk    | Market risk                                   | Market risk   |
| 3 | Counterparty risk  | Operational risk                              | Concentration risk                                    |
| 4 | Operational risk   | Regulatory risk                               | Operational risk                                      |
| 5 | Valuation risk     | Valuation risk                                | Credit risk   |
| 6 | Credit risk        | Credit risk                                   | Regulatory risk                                       |
| 7 | Litigation risk    | Concentration risk                            | Valuation risk  |
| 8 | Concentration risk | Litigation risk                               | Litigation risk                                       |

**Figure 5: 2010 - Predominant domicile of alternative funds**



**Figure 6: 2010 - Which areas of new regulation require improvements to be made within your organisation?**



surround the impact of high taxes, proposals for central counterparty clearing and UCITS IV.

The roundtable touched on the importance of onshore versus offshore and whether the financial crisis and the regulatory agenda would have a significant impact on fund domicile. Despite an adverse press, the survey data suggests that experienced investors continue to be comfortable with the current situation, with little change planned in the use of off-shore locations (Figure 5). Dyrberg 'presumed that there would be a shift to some of these jurisdictions in the face of regulation coming into the OTC market for the first time. As this and next year the regulation comes into effect, then I would be interested to see if that shift does take place.' Perhaps next year's survey will be better able to measure the impact of new regulation currently under consideration.

Unsurprisingly, the 2010 survey found that firms were generally confident that they are adequately equipped to comply

with regulatory challenges. Over half of respondents anticipate having no requirement to make material change to their business as a result of new regulation. Figure 6 shows that although major structural changes may not be necessary, new regulation is driving operational improvements and greater transparency, the reporting of OTC positions so far being by far the greatest area of change.

Jim Connor asked whether improvements in the treatment of regulatory risk were being held up by a lack of clarity from regulators themselves, and also pondered the effectiveness of the proposed Central Counterparty Clearing (CCP) system. There was agreement that further clarity is required, and a variety of views expressed in relationship to the CCP model.

Lassoud was of the view that 'the main concern on our side is what central counterparty clearing means in terms of valuation. Would CCPs be required to value all the positions and, if so, how are they going to address the common issues

around this? With CDS, for instance, indexes are liquid, but when you go to single names there will be some which have no liquidity - no spreads available.' The group agreed that it would be very interesting to see how the central counterparty addresses those kinds of issues surrounding more complex derivatives.

When asked to give some advice to the regulators around CCP and how it could develop, Lassoud responded saying 'the regulators should aim to produce a guideline so that the end clients can be completely in control of the whole process. For this to be the case on the valuation side and on the risk management side you need a huge push on the quality of the data - how it is checked qualitatively speaking - as well as the model and, finally, the interactivity with the provider. The ability to look at the pricing, and the assumptions behind pricing, as well as the reconciliation process as a whole, that's something that we think is really key to better risk management within the buy side.' Although these conversations would suggest that outsourcing providers could find a fertile market in regulatory support, the survey suggests that institutions are not ready to contract out these requirements. However, a quarter of firms did say they have outsourced these functions, and the lack of appetite in the others may arise from a lack of maturity in this market, itself a symptom of an incomplete phase of regulatory change.

## Summary

The asset management industry is emerging from the financial crisis. Confidence is growing resulting in a more balanced allocation of investment monies. End-investors have been chastened by losses and have relearned the old adage about only investing in what is understood. This has given risk management, particularly operational risk management, a turbo boost. End-investors, asset management firms, and the Regulators share the aim to minimize unrewarded risk. This is necessitating changes in product offerings better aligned to end-investor needs and want; an operating model in which risk management moves from being an afterthought to an integral part derivatives servicing; and greater engagement in the design of solutions and working practices of the market ecosystem.

The new reality is about understandable and sustainable investment performance: OTC derivatives play an important role in helping firms to meet investor expectations but applying the lesson of the financial crisis means putting risk on an equal footing to return in product design, operations, and market practice. ■